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DECLINING SUPPLY OF LOW AND MODERATE INCOME RENTAL HOUSING

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

THE DECLINE IN SUBSIDIZED UNITS EXPECTED DURING THE LATE 1980'S AND 1990'S ASSUMING OWNERS OPT OUT OF THE SECTION 8 OR SECTION 236 PROGRAMS WHEN THEIR CONTRACTUAL OBLIGATIONS EXPIRE

JUNE 5, 1987

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DECLINING SUPPLY OF LOW AND MODERATE INCOME RENTAL HOUSING

FRIDAY, JUNE 5, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, Proxmire, Heinz, D'Amato, Hecht, and Chafee.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. The hearing will please come to order.

Today's hearing concerns what may be the most pressing housing issue facing the Congress: The declining supply of rental housing available and affordable to low and moderate income people.

In recent years the number of poor people has steadily risen while the number of housing units available for their use has fallen. As a result, the Nation is being hit by a growing low income housing gap. Several factors could make the problem much worse in the next few years. First, we are losing thousands of low and moderate income housing units that have never received any Federal subsidies. They are being lost due to gentrification, condo conversions, disinvestment, and abandonment.

Second, thousands of privately owned but federally assisted housing units are about to be lost in the coming years through rental subsidy expirations and mortgage prepayments.

Finally, tax reform and budget cutbacks have shattered Federal efforts to expand the supply of affordable housing.

One focus of today's hearing will be the impending loss of low and moderate income housing assisted by HUD and Farmers Home. Over the course of the past year, the scope and nature of the problem have become increasingly clear. The General Accounting Office has estimated that the current inventory of low and moderate income housing could fall by 200,000 to 900,000 units by the year 1995 and by 1 million to 1.7 million units by the year 2005. Since the release of the GAO report, many groups have been working to provide Congress with more detailed analysis.

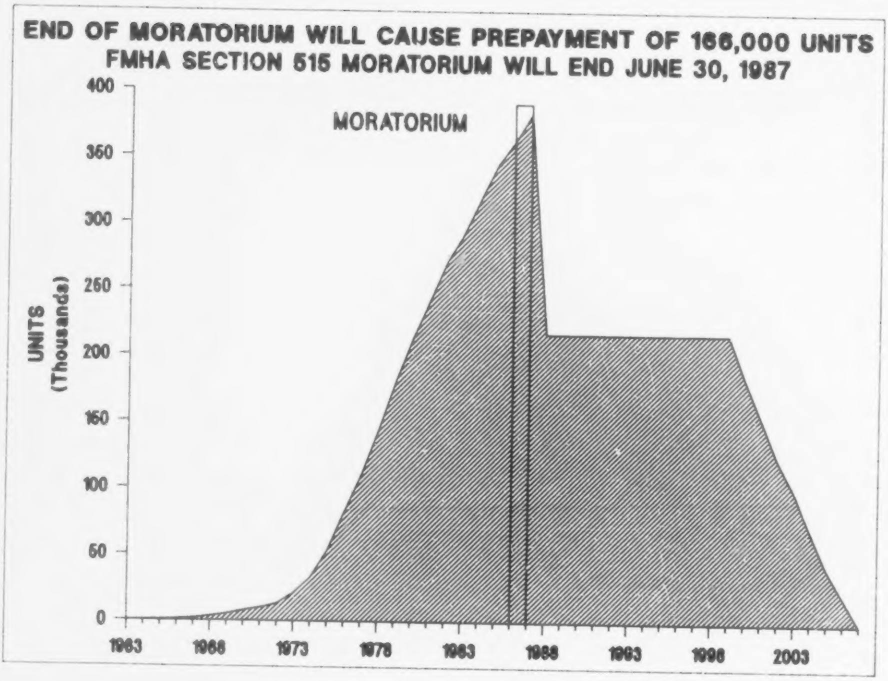
The graphs behind me dramatically show the threatening crisis. Graph 1 shows the number of section 515 rural housing units, after growing for years, would plummet after the current moratorium expires. About 166,000 units that were obligated prior to 1979 will be eligible for prepayment immediately. Starting in 1999, an additional 200,000 units will become eligible for prepayment.

Graph 2 shows that we soon stand to lose approximately 334,000 units of housing under the 236 and 221(d)(3) programs. The largest drop will occur between 1988 and 1994.

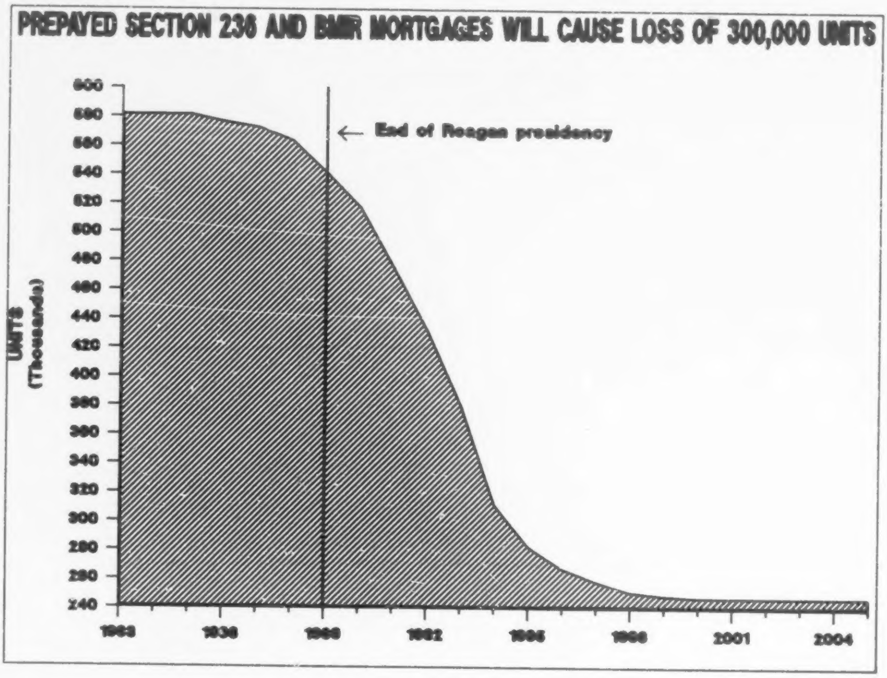
Graph 3 shows how almost 2 million units of section 8 housing is in danger of being lost. Project-based assistance will be lost as owners exercise their rights to opt-out. The tenant-based vouchers and certificates will need an appropriation of large amounts of new budget authority just to maintain the status quo.

The total loss of housing under all these programs could be as high as 2.5 million units. Although these represent a "worst case," they do not even consider the loss of public housing due to demolition, or the loss of low-rent housing through gentrification. Without overstating the problem, our country indeed has a crisis.

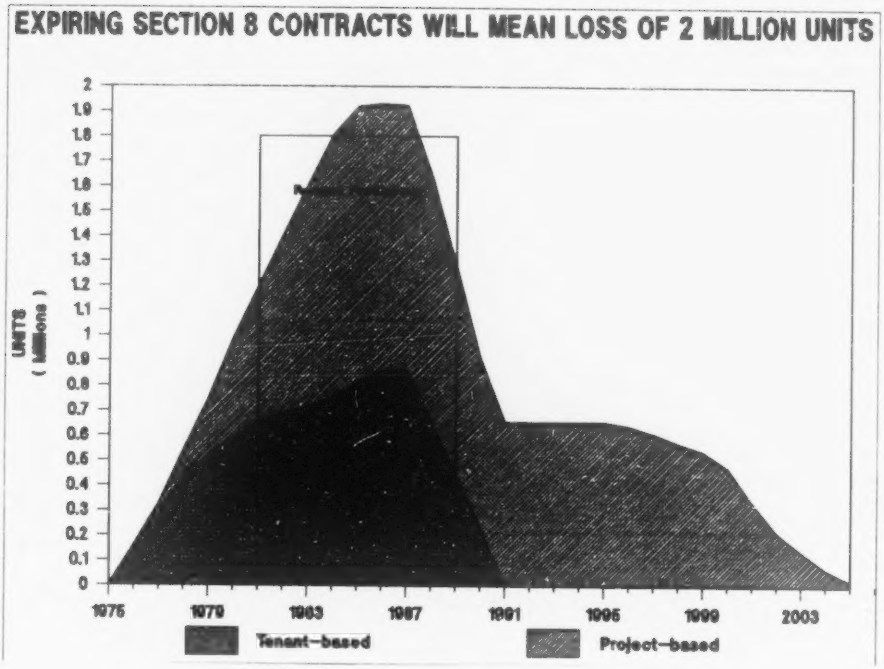
GRAPH 1



GRAPH 2



GRAPH 3



EXPIRING SECTION 8 CONTRACTS WILL MEAN LOSS OF 2 MILLION UNITS

Senator CRANSTON. We must not forget the human dimension of this problem. Millions of people could be displaced from their homes if, as predicted, the Nation loses over 40 percent of the Federally assisted housing stock over the next two decades. Our failure to find a solution would bring great hardship and suffering on those people who are least able to bear it.

As a Senator from California, I know first-hand about the real displacement that occurs when mortgages on federally assisted projects are prepaid. From 1984 to 1986, the prepayment of 35 loans under the section 515 program affected some 1,150 units in my State.

A study by the California Department of Housing and Community Development found that when loan prepayment occurred, tenants usually were hit by substantial rent increases. Some tenants tried to pay the increased rents and had to exhaust their savings or receive help from relatives until vacancies opened in scarce low income housing. Other tenants doubled up or moved in with relatives. The Department estimated that as many as 90 percent of the original low income tenants ultimately were displaced when Farmers Home mortgages were prepaid.

Congress temporarily halted this disruption when it imposed a moratorium on these prepayments last October. But that moratorium is now due to expire at the end of this month. Although we are trying to extend the moratorium through the end of the fiscal year, the problem will remain an urgent one.

The Farmers Home problem is just the tip of the iceberg. If such displacement of tenants begins to occur in HUD assisted apartment buildings across the country, we are going to witness a national calamity of the first order.

Congress must act responsibly and must act soon. When the Senate acted on the housing bill early this year, legislative proposals on this issue were not yet ripe. But the subcommittee has been giving the problem careful consideration. I am determined to come up with at least a stop-gap approach to this terrible problem in conference with the House while we continue to search for a long-term solution. I expect that the conference will begin within a month.

I believe a conference solution should adhere to the following general broad principles:

First, any solution should protect existing low- and moderate-income tenants. Most of the affected units are in areas where affordable housing is very difficult or impossible to find. We must make sure that people are not forced to move from decent housing into substandard housing or to live in overcrowded conditions or to join the growing ranks of the homeless.

Second, any solution should retain housing units that are affordable to low- and moderate-income people—whenever possible and for as long as possible. The Nation has made a heavy investment in Federally assisted housing, and the public has an interest in keeping it available to low- and moderate-income people. The cost of replacing it is now prohibitive.

Third, any solution should provide equitable treatment for the developers and owners of low- and moderate-income housing. The Federal Government established certain rules and expectations to encourage the private sector to produce affordable housing. We must continue this long-term partnership with the private sector. Congress should seek appropriate incentives for private investors to act in the national interest, to accept reasonable returns on their investment and to avoid displacement of low- and moderate-income people.

Fourth, any solution should prevent the executive branch from exacerbating the problem. If we are to retain our existing supply of affordable housing, careful and sophisticated work will have to be done on a project-by-project basis. We must not allow short-term, cosmetic budget strategies either to intensify pressures harmful to low income housing or to take away flexibility needed to preserve low income housing. The administration's efforts to raise revenues by selling off financial assets are particularly troublesome.

Finally, any solution we adopt this year should be sensitive to the complexity of the problem in future years. We should take only those short-term steps that lead to a long-term strategy for providing an adequate supply of affordable housing for all Americans.

I am grateful that an outstanding group of witnesses has agreed to join us today to offer their views on both the nature of the problem and possible legislative responses. As the Senate begins to fashion legislation in accordance with the principles I have outlined today, the contributions of both the oral and written testimony will be invaluable.

Senator PROXMIRE. I want to commend Senator Cranston, the Chairman of our Housing Subcommittee, on his diligence and productivity. He has already set a record for Senate Subcommittees in reporting major legislation to the floor and this hearing shows that he isn't letting up.

Senator CRANSTON. Senator D'Amato, do you have an opening statement?

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

First of all, I am pleased that you are addressing the issue of the prepayment of HUD and Farmers Home mortgages and the entire issue as it relates to low income housing and its stock here in America.

The prepayment of these mortgages has serious consequences for tenants occupying these projects. In addition, the prepayment of these mortgages could have a devastating effect on the low income housing stock of this Nation.

So I commend you, Senator Cranston, for holding these hearings and for your commitment to preserving the Nation's housing stock and protecting low income tenants.

The prepayment of the Farmers Home and HUD mortgages comes at a difficult time. Due to tax reform and reduced Federal funding, very little subsidized housing is being built. At the same time, much other housing is being lost to gentrification, abandonment and deterioration. Waiting lists for subsidized housing are long and growing.

A recent GAO report indicates that the current inventory of low income housing may be reduced by 200,000 units from the 1,100,000 that currently exist. Others estimate that the loss could be as great as 600,000 to 1 million units to replace the existing stock of such housing would cost more than $130 billion.

Within the next 15 years, 60 percent of the National total housing stock will be removed from regulations that ensure that the units are designated as housing for low income individuals.

The reality of the situation is that the Federal Government has invested a lot of money in low and moderate income housing. That investment may vanish in front of our very eyes unless we find a way to prevent it. The ramifications of the prepayment of Farmers Home section 515 and HUD section 221(d)(3) and 236 mortgages are similar.

If an owner of a Farmers Home or HUD project opts out of the mortgage contract, the project can lose its low income dedicated status with the tenants of the project subject to the whims of the owner. Owners can choose to develop the property or to raise rents. Once the owner opts out of the contract and prepays the balance of the mortgage, there is little further protection for those tenants.

In December 1986, Congress placed a 9-month moratorium on all prepayments of Farmers Home mortgages. Now this moratorium ends on June 30, 1987. An extension of this moratorium is included in the Senate version of the 1987 supplemental appropriations bill. Prior to the congressional imposition of a moratorium, over 5,000 section 515 units were lost.

Should the moratorium end, over 100,000 units would be available for prepayment at any time. I would suggest that that would add substantially to the problems of the homeless.

In addition to those two sets of mortgage contracts, a number of section 8 contracts are expected to expire beginning in 1989. Section 8 owners can opt out of the program when the 15 or 20 year contract expires. Opting out allows the owner to convert the existing units to market rate rentals. Prepayment of these mortgages and opting out of section 8 program raises grave questions about the preservation of low income housing stock.

Prepayment in the Farmers Home section 515 program are taking place in increasing numbers. In New York State, 9 such project owners already have opted to prepay, affecting 198 units. If the moratorium were not extended on the supplemental, a total of 186,515 units would be eligible for prepayment. Seventy-three percent of those units are occupied by very low income families, families with an income of under 50 percent of the area median income. Twenty percent are occupied by low income families, families with an income ranging between 50 to 80 percent of the area median income. Prepayment of these projects could and will displace many of these individuals. Now we're talking there about a number of 186,000 units.

As ranking member of this subcommittee, I am committed to working with you, Mr. Chairman, to ensure that this Nation has a long-term sensible commitment to low income housing stock. If our current programs are unable to reach this goal, a way must be found to give low income individuals some assurance that they will not be forced out of their existing homes because of termination of the Federal programs. That is something I think that we have got to make a priority.

It is my hope that this subcommittee will develop serious options for dealing with this problem. Incentives must be put into place to keep developers involved in low income housing. Incentives must be put into place to encourage new investors to invest in housing for low income individuals. And a mechanism must be found to ensure that low income individuals of accessible permanent housing continue to have that access.

As the House and Senate convene this summer in the housing bill conference, I hope that the Congress is committed to developing a feasible and concrete solution to this problem.

Mr. Chairman, I'd make one other aside if I might. There's no doubt in my mind that in coming up with a new tax code that we did serious, serious damage as it relates to the involvement of the private sector in the development of housing not only for low but moderate and working families, that there will be very little, if any, housing new initiatives that are started in the private sector, particularly as it relates to low-income groups and to groups of moderate means. We in the Congress should not, on the altar of the sloganeering "must be revenue neutral" and that if we open up the tax code to one thing that we'll be hit all over. I think those of us who recognize this situation, if we truly are looking to increase the Nation's housing stock, must address the kinds of incentives that are necessary to involve the private sector in the meaningful construction of this Nation's housing pool, that we simply cannot sit back and allow programs to be terminated or look to new Federal programs when we know that our colleagues are going to say we simply don't have the dollars. So it becomes absolutely imperative—and I think that this committee should not play second fiddle to the Tax Committee, to the Finance Committee, and the Ways and Means Committee in waiting for them to come forward. We have an obligation to be forceful advocates of the necessary changes that will increase the activity and the construction of rental units for the citizens of our Nation.

Mr. Chairman, I thank you for giving me this opportunity of making this statement and sharing these thoughts with you.

Senator CRANSTON. Thank you very much, Al. On the latter point, we will have a hearing soon, although we haven't set a date, on the effect of the changes in the tax code on housing. We have to document what has happened and we have to explore how we can cope with that. Since we don't have direct tax-writing responsibilities here, it's not easy, but we have a major responsibility for housing in this subcommittee and in this full committee. The Finance Committee has many other responsibilities. So that makes it complicated, but we will have to explore what we can do about that.

I'd like to ask the first panel to now come to the table and I'd like also to ask Secretary Demery to join you at the table. He is going to testify out of the planned sequence because he has an early obligation. I believe the members of the first panel are Marvin Siflinger, William Apgar, and Susan Peck.

It's our pleasure to have as our first witness Thomas Demery, Assistant Secretary for Housing, Department of Housing and Urban Development. I want to ask you, Mr. Secretary, and all the other witnesses, to please summarize your full statement in 5 minutes. Your full written statement will be included in the record and we will also keep the record open for 2 weeks for you to respond to any additional questions that any Senator may have and any additional questions will be sent to you within 1 week of this hearing. We hope you can respond within 1 week thereafter.

Good morning, Secretary Demery. Please proceed.

STATEMENT OF THOMAS DEMERY, ASSISTANT SECRETARY FOR HOUSING, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. DEMERY. Good morning, Mr. Chairman. I hope very much that my testimony is in order.

Senator CRANSTON. Yes, it is. It had better be.

Mr. DEMERY. As you indicated, I'm the Assistant Secretary for Housing, Federal Housing Commissioner, of HUD, and I'm pleased to be here this morning to offer this subcommittee my assistance as it examines the preservation issue.

I believe that if we are to deal successfully with this problem we must keep certain points in mind, the first one being that we have to know the problem. HUD and other concerned groups are collecting data so that we will have a detailed knowledge of the scope, width and breadth of the problem.

Second, I think we must maintain an attitude of flexibility in designing solutions. We must be able to design them on a case-by-case basis as circumstances and situations warrant and dictate.

Third, the concept of teamwork is extremely important. We are all in this together at all levels. We are a partnership, if we're going to solve this problem, of the State, Federal and local governments, as well as the private sector, the owners of that real estate.

DATA ANALYSIS

You have asked me to focus on our data analysis at this hearing. Our study covers projects of subsidized mortgages with prepayment restrictions. This stock includes section 236 projects, and section 221(d)(3) below-market interest rate projects, section 221(d)(3) market rate projects with rent supplement assistance. The study includes 221(d)(3) market rate mortgages which have been converted from rent supplement to section 8 assistance under the loan management program.

Our study identified this universe and then broke it down into two large categories—projects ineligible at any time to prepay without HUD approval, and projects which will become eligible to prepay without HUD approval after 20 years.

Within this latter group we then obtained the field office assessment of the likelihood of projects prepaying based upon an analysis of the project's characteristics and conditions and, where possible, their knowledge of owner intent.

We subdivided the eligible universe into 4 categories—those projects which will prepay, those projects which are likely to prepay, those that are unlikely, and those that will not prepay.

In terms of units or households served, about 75 percent of the stock in the survey is ineligible, unlikely, or simply will not prepay, due to market conditions and characteristics. About 25 percent, the remaining 25 percent, we've determined to be likely or will definitely prepay. This portion, some 154,000 units, represents about 3.6 percent of HUD's assisted housing stock which contains a total universe of about 4.2 million HUD assisted residential units.

We are continuing to collect and refine the data we already have. We will provide information to the subcommittee as our work products become completed and are available.

We are also working, I might add, with outside groups. We have been acting as a technical resource for two groups working on the prepayment issue. One is the National Low Income Housing Preservation Commission and the other is the Council of Management Agents. Our data is and will continue to be useful to these groups.

As we've developed data we have shared it with Congress, private groups, and the Congressional Budget Office. All of these groups understand how important it is to know the problem first before solutions are developed. Moreover, we believe that until we and these other groups complete the thorough and thoughtful analyses to which all of us are committed, it might be premature for the Congress to fashion a response to the complex questions raised by prepayment and preservation.

Second, the subcommittee is concerned about the extent to which the legislation proposed in H.R. 4 would further the preservation of low income rental housing. Generally, I don't believe that this is the time to establish any new subsidy programs or to be over-restrictive of HUD's policies and procedures. We should realize that the circumstances surrounding prepayment are neither simple or uniform. The needs of tenants, neighborhoods, and owners are unique in each case.

We remain strongly committed to helping people. We will also provide housing vouchers for all section 8 contract expirations. Also, we have included in our fiscal year 1988 budget a line item for housing vouchers for eligible tenants affected by prepayments of section 236 and 221(d)(3) mortgages. This will assure continuation of housing assistance for eligible tenants in the event of a mortgage prepayment.

Third, the subcommittee wants to know what can be done now. I have identified a number of actions in previous testimony to the House on this subject and have included them in my written statement.

We are assessing their effectiveness in the Department right now.

We have also received inquiries about allowing early prepayment with an agreement to maintain the project for low income tenants for a period of time beyond the 20th year or allowing inducements prior to the prepayment date with the agreement to extend the lock-in period for up to 10 more years.

In summary, we are reviewing both our resources and external proposals and will keep you advised of our progress. A Federal, State and private partnership is what I see to be the bright spot and ultimate solution in addressing the prepayment issue. I have met with, as I said, outside groups and will continue to do so. I see my time is up.

We are committed to working with the subcommittee and all of those affected and concerned with this issue, sir, and I stand ready to answer any questions that you may have to ask of me.

[The complete prepared statement of Thomas Demery follows:]

TESTIMONY OF
THOMAS T. DEMERY
ASSISTANT SECRETARY FOR HOUSING--
FEDERAL HOUSING COMMISSIONER

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Before the
SENATE SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

June 5, 1987

Good morning. My name is Tom Demery. I am the Assistant Secretary for Housing/Federal Housing Commissioner.

Mr. Chairman, I am very pleased to be here today to offer my assistance to the Subcommittee as you examine the preservation issue. Specifically, all of us are just beginning to come to grips with examining options concerning Section 221 (d)(3) and Section 236 prepayment issues. In March, I testified at a similar hearing conducted by the House.

At that time, I emphasized several points:

- That before precipitate action is taken by Congress or the Administration, we must know the true scope of the problem. In this regard, we have a substantial data collection effort underway at the Department.
- That there is no one solution that will resolve the problems when we find they exist. We must be flexible in designing approaches to multifamily preservation. We must be attuned to the complexity of each situation, on a case-by-case basis.

- That the solution to problems we find does not rest with solely the Federal Government. One theme I stressed was partnership -- between levels of government and between the private and public sectors. We have taken steps to encourage this partnership and to consult with government and industry groups. The concept of teamwork, with each member doing its part, is the essence of any solution to complex issues.

You have asked me to focus on our data analysis at this hearing. I will go over our results so far.

Our study covers projects with subsidized mortgages with prepayment restrictions. This stock includes Section 236 projects, Section 221(d)(3) below market interest rate (BMIR) projects, and Section 221(d)(3) market rate projects with Rent Supplement assistance. The study includes Section 221(d)(3) market rate mortgages which have converted from Rent Supplement to Section 8 assistance under the Loan Management program.

Projects insured under the Section 236, Section 221(d)(3) market rate, and Section 221(d)(3) below market interest rate (BMIR) programs have prepayment restrictions for either 20 years or the term of the mortgage. Limited distribution mortgagors whose projects do not receive Rent Supplement assistance can prepay their mortgages without HUD's consent after 20 years. Nonprofit mortgagors, and limited distribution mortgagors whose projects receive Rent Supplement Assistance, may not prepay their mortgages without HUD's consent during the entire term of the mortgage. In addition, if a project receives Flexible Subsidy assistance, the project owner is required to maintain the low and moderate income character of the project for a term at least equal to the remaining term of the mortgage, even if the mortgage is prepaid.

The study identified this universe, and then broke it down into two large categories: projects ineligible at any time to prepay without HUD approval and projects which will become eligible to prepay without HUD approval after 20 years. Within this latter group, we then obtained the field office assessment of the likelihood of projects prepaying, based upon analysis of the project's characteristics and condition, and, where possible, knowledge of owner intent. We subdivided the eligible universe into four categories: those projects which will prepay; those projects likely to prepay; those that are unlikely to prepay; and those that will not prepay.

THE RESULTS ARE INTERESTING:

-- THE TOTAL UNIVERSE OF PROJECTS CONSISTED OF 5420 PROJECTS WITH 604,460 UNITS;

-- FORTY (40) PERCENT OF THE UNIVERSE, OR 2177 PROJECTS WITH 240,906 UNITS, WOULD BE INELIGIBLE TO PREPAY WITHOUT HUD APPROVAL FOR THE FULL TERM OF THE 40-YEAR MORTGAGE. GENERALLY, THIS INELIGIBILITY RESULTS FROM NON-PROFIT SPONSORSHIP.

-- SIXTY (60) PERCENT OF THE UNIVERSE, OR 3243 PROJECTS WITH 363,554 UNITS, WILL AT SOME POINT EMERGE FROM A LOCK-IN PERIOD (20 YEARS AFTER FINAL ENDORSEMENT);

-- OF THIS GROUP, WE ESTIMATE THAT 739 PROJECTS WITH 84,257 UNITS WILL PREPAY. OUR ASSESSMENT IS THAT LOCAL MARKET CONDITIONS ARE SUCH THAT THESE RELATIVELY BETTER PROJECTS WILL PROPOSE TO LEAVE THE INVENTORY;

-- THERE ARE 622 PROJECTS WITH 70,022 UNITS THAT ARE LIKELY TO PREPAY. THESE PROJECTS ARE NOT SO CLEARLY WELL LOCATED OR SO CLEARLY MARKETABLE THAT PREPAYMENT CONSTITUTES THE HIGHEST AND BEST USE OF THE PROPERTY, BUT THEY ARE VIABLE AND IT IS LIKELY THAT THEY WILL BE SUBJECT TO PREPAYMENT;

-- 1825 PROJECTS WITH 203,285 UNITS ARE EITHER UNLIKELY TO PREPAY OR SIMPLY WILL NOT PREPAY THEIR MORTGAGES.

THEREFORE, IN TERMS OF UNITS -- OR HOUSEHOLDS SERVED -- ABOUT 75 PERCENT OF THE STOCK IN THE SURVEY IS INELIGIBLE, UNLIKELY, OR SIMPLY NOT GOING TO PREPAY. ABOUT 25 PERCENT OF THE STOCK WILL OR IS LIKELY TO PREPAY. THIS PORTION, SOME 154,000 UNITS, REPRESENTS ABOUT 3.6 PERCENT OF HUD'S ASSISTED HOUSING STOCK (WHICH CONSISTS OF A TOTAL UNIVERSE OF 4.2 MILLION HUD ASSISTED RESIDENTIAL HOUSING UNITS). SUMMARY DATA AND TABLES ARE ATTACHED TO THIS STATEMENT.

THE HIGHLIGHTS ARE:

		PROJECTS	UNITS
A.	TOTAL 221(D)(3) AND 236* INVENTORY	5,420	604,460
B.	LEGALLY INELIGIBLE TO PREPAY**	2,177 (40%)	240,906 (40%)
C.	LEGALLY ELIGIBLE TO PREPAY	3,243 (60%)	363,554 (60%)
D.	WILL DEFINITELY PREPAY	739	84,257
E.	LIKELY TO PREPAY	622	70,022
F.	UNLIKELY TO PREPAY	486	52,469
G.	WON'T PREPAY	1,339	150,816
H.	UNKNOWN	57	5,990
I.	PRIMARY AREA OF FOCUS (D&E AS A PERCENTAGE OF A)	1,361(25%)	154,279 (25%)

* ALL DATA GENERATED FROM HUD MARCH 1987 PREPAYMENT & SURVEY ANALYSIS

** PROJECTS THAT WERE FINALLY ENDORSED AS NOT-FOR-PROFIT PROJECTS OR PROJECTS THAT HAVE RENT SUPPLEMENT UNITS

The data I've just summarized was collected in March of 1987. We have not finished this work. For example, we completed a list of projects, by state, which indicated their eligible or ineligible status. But, the initial data did not include a timeline for projects -- that is, a specific schedule for when the eligible category of projects would become eligible. We now have this information. A significant number begin to enter this period in 1989. We will supply the Subcommittee a list of projects arranged by the date (day-month-year) on which the owner will be able to pre-pay without HUD approval.

In addition, we are now working on refining our current information. As I've indicated, in establishing categories of projects our Field Offices made an assessment of the likelihood of prepayment in the context of each project's location, amenities, market conditions, and tenant composition. More work needs to be done in this regard. We will:

- Take a more critical look at which projects are likely to exercise the right to prepay.

- Get more data on the current rents and incomes of families in these projects.

- Integrate data on prepayments with data on Section 8 contract terminations.

- Determine which, if any, of the projects likely to prepay have received Flexible Subsidy assistance. While those projects may prepay, the owner must keep the units available for low and moderate income families for the original term of the mortgage.

A memorandum to the field offices has been sent requesting this information.

A special note needs to be made of our work with outside groups. We have been acting as a technical resource for two working groups beginning to assess the prepayment question. One is the National Low Income Housing Presevation Commission -- a blue-ribbon bipartisan panel co-chaired by Carla Hills and Henry Reuss looking into the preservation issue. This Commission is scheduled to send its findings and recommendations to the Congress in January of 1988. The other group with which we are working is the Council of Management Agents, which is also examining the prepayment question. Our data is and will continue to be useful to these groups. I think we all share the belief that a solid grounding in the facts is an essential first step for addressing the questions at hand.

Moreover, we believe that until we and these other groups complete the thorough and thoughtful analyses to which all of us are committed, it might be premature for the Congress to fashion a response to complex questions raised by prepayment and preservation.

We have made an effort to share our findings as we have developed the data. We have provided the Congress various information on the prepayment inventory; we have worked with private groups; and, we have given the Congressional Budget Office our updated information.

A second area of concern that has been expressed by the Subcommittee is the extent to which prospective legislation embodied in H.R.4 will abet the preservation of lower-income rental housing. I can give you a general response. We do not believe this is the time to establish new subsidy programs, or absent that, overly restrictive policies and procedures that preempt our ability to manage the multifamily inventory. We should realize that the circumstances surrounding prepayment are neither simple nor uniform. The needs of tenants, neighborhoods, and owners are often different in each case. HUD's overall role with regard to the prepayment and Section 8 contract expiration situation is that of helping people. We will be providing Housing Vouchers for all contract expirations. In addition, we have included in our FY 1988 Budget a line item for Housing Vouchers for eligible tenants affected by prepayments of Section 236 and Section 221(d)(3) mortgages. This will assure a continuation of housing assistance for eligible tenants in the event of a mortgage prepayment.

I know the issue has been raised as to how vouchers can be used in tight markets. Our answer is that if a local submarket is tight, State and local governments ought to respond because there is simply no justification for a national rental production program. States have had the opportunity and have acted to develop all manner of housing programs, production and rehabilitation efforts included. The tax credit program for low-income housing offers an additional tool that could be used -- in fact, targetted to tight markets. For their part local governments would be able to use CDBG funds for new contruction, under our FY 1988 legislative recommendations.

A third area of concern of the Subcommittee is what steps can be taken now. In March testimony, I identified a number of specific actions. Among these are:

-- Observe the requirements of Section 250 of the National Housing Act as they relate to approving prepayment actions. Up to the present time, HUD has processed only a few requests for approval to prepay the mortgage under Section 250(a). In each case the project owner has complied with Section 250(a)(1) by executing and recording a use agreement

OBLIGATING THE OWNER TO MAINTAIN THE PROJECT AS LOW-INCOME OR LOW MODERATE INCOME HOUSING UNTIL AT LEAST THE EXPIRATION OF THE "LOCK-IN" PERIOD.

-- IMPOSE APPROPRIATE USE RESTRICTIONS ON THE PURCHASERS OF PROJECTS AT FORECLOSURE, WHETHER THE FORECLOSURE IS CONDUCTED PURSUANT TO THE MULTIFAMILY MORTGAGE FORECLOSURE ACT OR OTHERWISE. IN ACCORDANCE WITH OUR REGULATIONS, THE USE RESTRICTIONS REMAIN IN EFFECT UNTIL THE EXPIRATION OF THE "LOCK-IN" PERIOD UNDER THE MORTGAGE BEING FORECLOSED. THERE ARE TWO EXCEPTIONS TO THIS RULE: HUD IS NOT IMPOSING USE RESTRICTIONS ON PROJECTS WHICH ARE VACANT AT THE TIME OF FORECLOSURE, OR ON PROJECTS WHERE THE "LOCK-IN" PERIOD WOULD EXPIRE WITHIN ONE YEAR OF THE FORECLOSURE.

-- ENFORCE THE STATUTORY USE RESTRICTION REQUIRED OF PROJECTS RECEIVING FLEXIBLE SUBSIDY ASSISTANCE;

-- WHERE OWNERS OPT OUT OF SECTION 8 CONTRACTS, PROVIDE HOUSING VOUCHERS TO THE TENANTS. ALTHOUGH OPT-OUT ACTIVITY HAS BEEN VERY SLIGHT DURING FY 1985 AND 1986 (248 AND 1007 UNITS, RESPECTIVELY, AND 298 UNITS AS OF 2ND QUARTER FY 1987) WE HAVE IMPLEMENTED A NEW MANAGEMENT CONTROL SYSTEM FOR ASSESSING PROJECT DATA IN OPT-OUT CASES, INCLUDING THE OWNER'S REASON FOR OPTING OUT OF THE CONTRACT.

-- CONSIDERATION OF INCREASED OWNER INCENTIVES TO REMAIN IN PLACE. WHERE MARKET CONDITIONS WARRANT HUD CAN ALLOW OWNERS AN INCREASED EQUITY TAKEOUT IN RETURN FOR AN EXTENSION OF THE LOCK-IN PERIOD. HUD CAN DO THIS IN SEVERAL WAYS: BY INCREASING THE DISTRIBUTION RATE AN OWNER MAY TAKE; BY INCREASING THE BASIS ON WHICH AN OWNER FIGURES HIS DISTRIBUTION; OR BY ALLOWING AN OWNER TO TAKE A SECOND MORTGAGE ON THE PROPERTY TO ACCESS SOME OF HIS EQUITY.

-- INCREASED EMPHASIS UPON TIGHT MARKET CONDITIONS. WE WILL CONSIDER MAKING A SPECIAL REQUIREMENT APPLICABLE TO PREPAYMENT REQUESTS IN TIGHT MARKET AREAS (UNDER 3 PERCENT VACANCY RATE). THIS WOULD MAKE THE CURRENT TEST UNDER SECTION 250 MORE EFFECTIVE.

-- FINALLY, ONE OF THE PROMISING TOOLS AVAILABLE IS THE TAX CREDIT PROGRAM CONGRESS CREATED IN LAST YEAR'S TAX REFORM ACT. WHILE THE CREDIT WON'T WORK FOR ALL PROJECTS, IN SOME INSTANCES THE CREDIT CAN HELP TO PRESERVE UNITS FOR LOW AND MODERATE INCOME FAMILIES.

Such options are open to us, and we have had dealings with owners who have wanted to explore the inducements available to keep projects in their current status. While HUD has not approved any new proposals to extend the "lock-in" period since it approved the Washington Dodd proposal, we have received initial inquiries about allowing early prepayment with an agreement to maintain the project for lower income tenants for a period of time beyond the twentieth year or allowing inducements prior to the prepayment date with agreement to extend the "lock-in" period for up to 10 more years. We are reviewing the proposals and will keep you advised as we progress.

A Federal, State and private partnership is what I see to be the real bright spot and ultimate solution in addressing the issue. I've already met with the Council of State Housing Agencies and several individual State Housing Agencies to enlist their support in complementing HUD's efforts. For example, I believe the Council of State Housing Agencies is developing data on state-assisted projects. In addition, CSHA is a member of the two working groups I've mentioned. This coordinative effort extends to the use of the tax credit program as well, particularly with respect to use of the credit with our assisted stock as a means of preserving lower-income housing.

Not all the steps outlined above will apply to every prepayment or contract expiration case. We may lose some units to strong markets, regardless of incentives that we can come up with. Additionally, tax credits may provide treatment for only a portion of the subject stock. This will demand a case-by-case approach and sensitivity to market areas where the projects are located. A lot of hard and innovative work lies ahead -- for Congress, private industry, the Department, and for all levels of government.

Attachment A

05-Mar-87

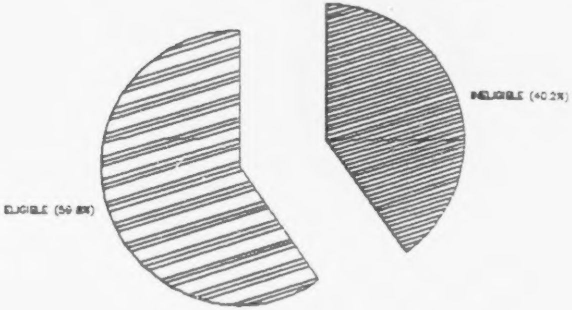
TABLE 1

PREPAYMENT SURVEY: ELIGIBILITY COMPARISON

REGION	TOTAL PROJECTS (ELIGIBLE + INELIGIBLE)		LEGALLY INELIGIBLE PROJECTS				LEGALLY ELIGIBLE PROJECTS			
	NUMBER OF PROJECTS	NUMBER OF UNITS	NUMBER OF PROJECTS	% OF NATIONAL TOTAL	NUMBER OF UNITS	% OF NATIONAL TOTAL	# OF PROJECTS	% OF NATIONAL TOTAL	# OF UNITS (INCLUDES T-B SUBSIDY)	% OF NATIONAL TOTAL
I	404	51,991	96	2%	8,060	1%	308	6%	43,931	7%
II	321	45,243	138	3%	20,290	3%	183	3%	24,953	4%
III	503	73,600	175	3%	20,181	3%	328	6%	53,419	9%
IV	703	78,124	176	3%	22,579	4%	527	10%	55,545	9%
V	1,106	126,703	624	12%	66,441	11%	482	9%	60,262	10%
VI	587	72,015	239	4%	28,862	5%	348	6%	43,153	7%
VII	301	33,890	141	3%	17,766	3%	160	3%	16,124	3%
VIII	290	19,614	95	2%	7,546	1%	195	4%	12,068	2%
IX	865	85,230	450	8%	46,460	8%	415	8%	38,770	6%
X	340	18,050	43	1%	2,721	0%	297	5%	15,329	3%
NATIONAL	5,420	604,460	2,177	40%	240,906	40%	3,243	60%	363,554	60%

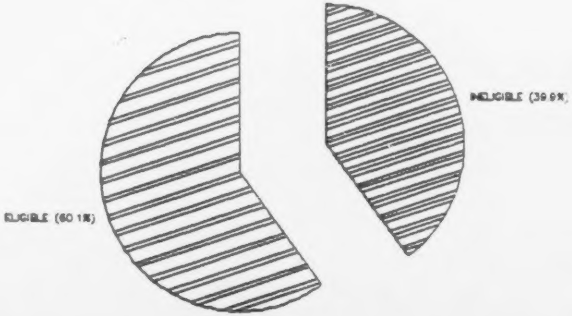
GRAPH 1A

NATIONAL ELIGIBILITY PROFILE (PROJECTS)



GRAPH 1B

NATIONAL ELIGIBILITY PROFILE (UNITS)



05-Mar-87

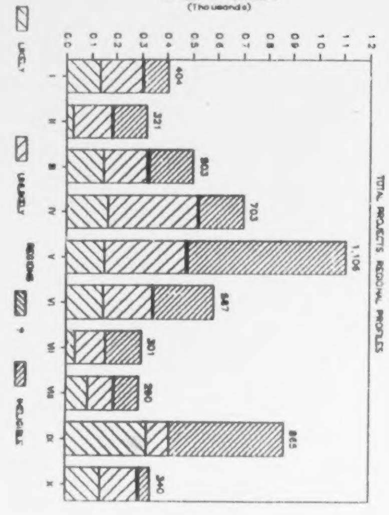
TABLE 2
OFFICE OF MULTIFAMILY HOUSING MANAGEMENT PREPAYMENT SURVEY
ANALYSIS OF PREPAYMENT LIKELIHOOD

PROJECT PREPAYMENT PROFILES
WITH PERCENTAGES OF NATIONAL TOTAL PROJECTS (BOTH ELIGIBLE AND INELIGIBLE)

REGION	WILL PREPAY	% OF NATIONAL TOTAL PROJECTS	PREPAYMENT LIKELY	% OF NATIONAL TOTAL PROJECTS	TOTAL PROJECTS; LIKELY+WILL PREPAY	% OF NATIONAL TOTAL PROJECTS	WON'T PREPAY	% OF NATIONAL TOTAL PROJECTS	PREPAYMENT UNLIKELY	% OF NATIONAL TOTAL PROJECTS	TOTAL PROJECTS; UNLIKELY+ WON'T PREPAY	% OF NATIONAL TOTAL PROJECTS	UNKNOWN LIKELIHOOD OF PREPAYMENT	% OF NATIONAL TOTAL PROJECTS
I	34	0.63%	98	1.81%	132	2.44%	135	2.49%	32	0.59%	167	3.08%	9	0.17%
II	23	0.42%	3	0.06%	26	0.48%	139	2.56%	17	0.31%	156	2.88%	1	0.02%
III	88	1.62%	59	1.09%	147	2.71%	113	2.08%	62	1.14%	175	3.23%	6	0.11%
IV	68	1.25%	97	1.79%	165	3.04%	240	4.43%	113	2.08%	353	6.51%	9	0.17%
V	95	1.75%	58	1.07%	153	2.82%	266	4.91%	53	0.98%	319	5.88%	10	0.18%
VI	42	0.77%	106	1.96%	148	2.73%	107	1.97%	89	1.64%	196	3.61%	4	0.07%
VII	21	0.39%	17	0.31%	38	0.70%	100	1.85%	21	0.39%	121	2.23%	1	0.02%
VIII	18	0.33%	71	1.31%	89	1.64%	73	1.35%	28	0.52%	101	1.86%	5	0.09%
IX	305	5.63%	19	0.35%	324	5.98%	87	1.61%	3	0.06%	90	1.66%	1	0.02%
X	45	0.83%	94	1.73%	139	2.56%	79	1.46%	68	1.25%	147	2.71%	11	0.20%
NATIONAL	739	13.63%	622	11.48%	1,361	25.11%	1,339	24.70%	486	8.97%	1,825	33.67%	57	1.05%

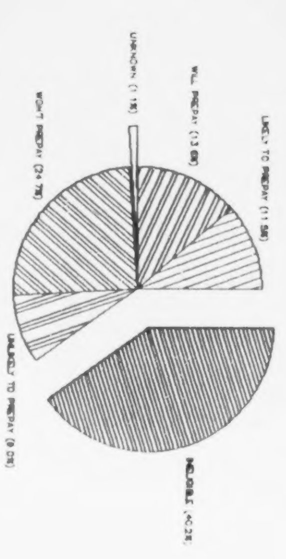
GRAPH 2B

TOTAL PROJECTS REGIONAL PROFILES



GRAPH 2A

PERCENTAGE OF NATIONAL TOTAL PROJECTS

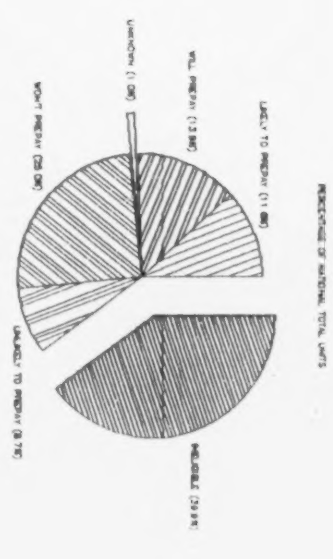


05-Mar-87

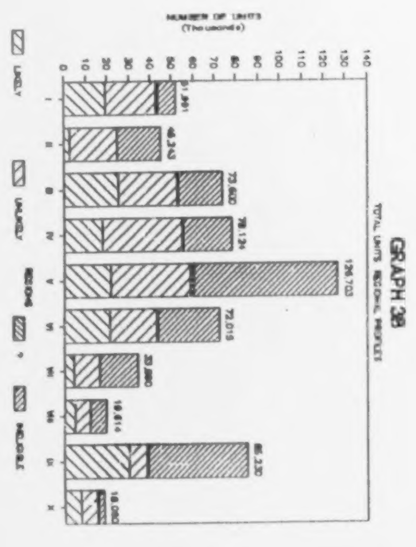
TABLE 3
OFFICE OF MULTIFAMILY HOUSING MANAGEMENT PREPAYMENT SURVEY
ANALYSIS OF PREPAYMENT LIKELIHOOD

UNIT PREPAYMENT PROFILES
WITH PERCENTAGES OF NATIONAL TOTAL UNITS (BOTH ELIGIBLE AND INELIGIBLE)

REGION	WILL PREPAY	% OF NATIONAL TOTAL UNITS	PREPAYMENT LIKELY	% OF NATIONAL TOTAL UNITS	TOTAL UNITS: LIKELY+WILL PREPAY	% OF NATIONAL TOTAL UNITS	WON'T PREPAY	% OF NATIONAL TOTAL UNITS	PREPAYMENT UNLIKELY	% OF NATIONAL TOTAL UNITS	TOTAL UNITS: UNLIKELY+ WON'T PREPAY	% OF NATIONAL TOTAL UNITS	UNKNOWN LIKELIHOOD OF PREPAYMENT	% OF NATIONAL TOTAL UNITS
I	5,333	0.88%	14,201	2.35%	19,534	3.23%	19,195	3.18%	4,016	0.66%	23,211	3.84%	1,186	0.20%
II	1,966	0.33%	500	0.08%	2,466	0.41%	19,203	3.18%	3,092	0.51%	22,295	3.69%	192	0.03%
III	15,305	2.53%	10,172	1.68%	25,477	4.21%	17,955	2.97%	9,041	1.50%	26,996	4.47%	946	0.16%
IV	7,722	1.28%	10,232	1.69%	17,954	2.97%	25,436	4.21%	11,350	1.88%	36,787	6.09%	804	0.13%
V	14,614	2.42%	6,790	1.12%	21,404	3.54%	31,061	5.14%	6,353	1.05%	37,414	6.19%	1,444	0.24%
VI	4,791	0.79%	16,000	2.65%	20,791	3.44%	10,698	1.77%	11,427	1.89%	22,125	3.66%	237	0.04%
VII	2,564	0.42%	1,476	0.24%	4,040	0.67%	9,612	1.59%	2,376	0.39%	11,988	1.98%	96	0.02%
VIII	1,315	0.22%	3,480	0.58%	4,795	0.79%	5,133	0.85%	1,651	0.27%	6,784	1.12%	489	0.08%
IX	27,838	4.61%	2,584	0.43%	30,422	5.03%	8,106	1.34%	186	0.03%	8,292	1.37%	56	0.01%
X	2,809	0.46%	4,587	0.76%	7,396	1.22%	4,337	0.72%	3,056	0.51%	7,393	1.22%	540	0.09%
NATIONAL	84,257	13.94%	70,022	11.58%	154,279	25.52%	150,816	24.95%	52,469	8.68%	203,285	33.63%	5,990	0.99%


GRAPH 3A

PERCENTAGE OF NATIONAL TOTAL UNITS


GRAPH 3B

TOTAL UNITS: REGIONAL PROFILES

09-Mar-87

TABLE 4

OFFICE OF MULTIFAMILY HOUSING MANAGEMENT PREPAYMENT SURVEY

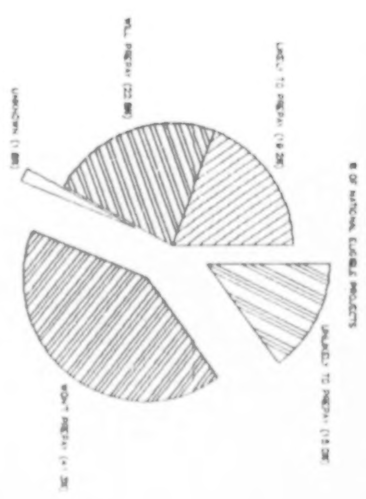
ANALYSIS OF PREPAYMENT LIKELIHOOD

PROJECT PREPAYMENT PROFILES
WITH PERCENTAGES OF NATIONAL ELIGIBLE PROJECTS

REGION	TOTAL ELIGIBLE PROJECTS	WILL PREPAY	% OF NATIONAL ELIGIBLE PROJECTS	PREPAYMENT LIKELY	% OF NATIONAL ELIGIBLE PROJECTS	TOTAL PROJECTS: LIKELY+WILL PREPAY	% OF NATIONAL ELIGIBLE PROJECTS	WON'T PREPAY	% OF NATIONAL ELIGIBLE PROJECTS	PREPAYMENT UNLIKELY	% OF NATIONAL ELIGIBLE PROJECTS	TOTAL PROJECTS: UNLIKELY+ WON'T PREPAY	% OF NATIONAL ELIGIBLE PROJECTS	UNKNOWN LIKELIHOOD OF PREPAYMENT	% OF NATIONAL ELIGIBLE PROJECTS
I	308	34	1.05%	98	3.02%	132	4.07%	135	4.16%	32	0.99%	167	5.15%	9	0.28%
II	183	23	0.71%	3	0.09%	26	0.80%	139	4.29%	17	0.52%	156	4.81%	1	0.03%
III	328	88	2.71%	59	1.82%	147	4.53%	113	3.48%	62	1.91%	175	5.40%	6	0.19%
IV	527	68	2.10%	97	2.99%	165	5.09%	240	7.40%	113	3.48%	353	10.88%	9	0.28%
V	482	95	2.93%	58	1.79%	153	4.72%	266	8.20%	53	1.63%	319	9.84%	10	0.31%
VI	348	42	1.30%	106	3.27%	148	4.56%	107	3.30%	89	2.74%	196	6.04%	4	0.12%
VII	160	21	0.65%	17	0.52%	38	1.17%	100	3.08%	21	0.65%	121	3.73%	1	0.03%
VIII	195	18	0.56%	71	2.19%	89	2.74%	73	2.25%	28	0.86%	101	3.11%	5	0.15%
IX	415	305	9.40%	19	0.59%	324	9.99%	87	2.68%	3	0.09%	90	2.78%	1	0.03%
X	297	45	1.39%	94	2.90%	139	4.29%	79	2.44%	68	2.10%	147	4.53%	11	0.34%
NATIONAL	3,243	739	22.79%	622	19.18%	1,361	41.97%	1,339	41.29%	486	14.99%	1,825	56.28%	57	1.76%

GRAPH 4A

% OF NATIONAL ELIGIBLE PROJECTS



GRAPH 4B

ELIGIBLE PROJECTS, REGIONAL PROFILES

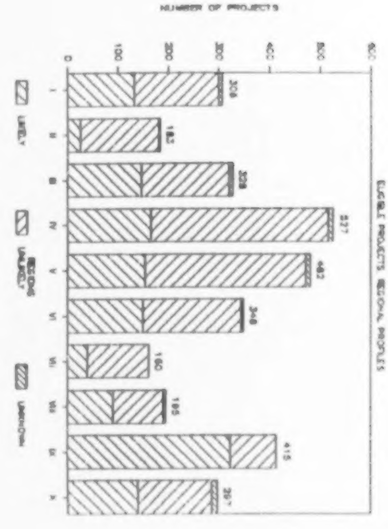


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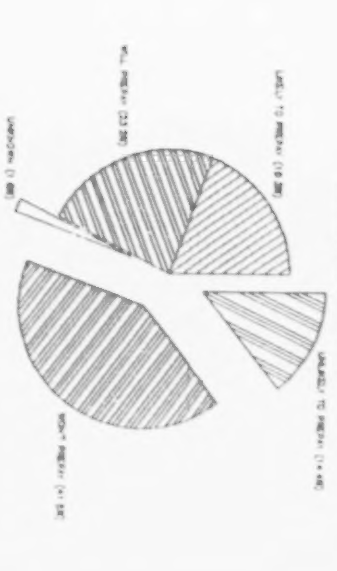
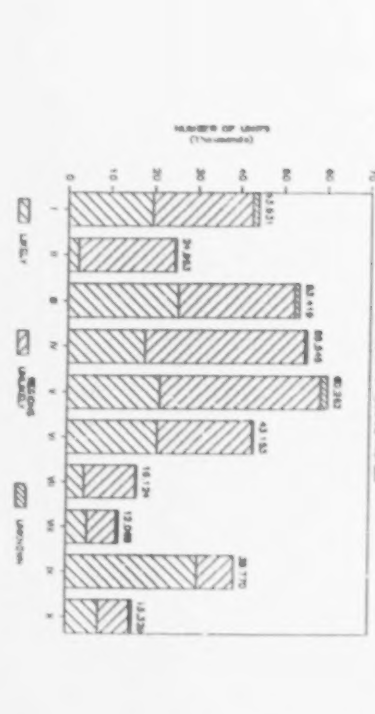
TABLE 5
OFFICE OF MULTIFAMILY HOUSING MANAGEMENT PREPAYMENT SURVEY
ANALYSIS OF PREPAYMENT LIKELIHOOD

UNIT PREPAYMENT PROFILES
WITH PERCENTAGES OF NATIONAL ELIGIBLE UNITS

REGION	TOTAL ELIGIBLE UNITS	WILL PREPAY	% OF NATIONAL ELIGIBLE UNITS	PREPAYMENT LIKELY	% OF NATIONAL ELIGIBLE UNITS	TOTAL UNITS: LIKELY+WILL PREPAY	% OF NATIONAL ELIGIBLE UNITS	WON'T PREPAY	% OF NATIONAL ELIGIBLE UNITS	PREPAYMENT UNLIKELY	% OF NATIONAL ELIGIBLE UNITS	TOTAL UNITS: UNLIKELY+ WON'T PREPAY	% OF NATIONAL ELIGIBLE UNITS	UNKNOWN LIKELIHOOD OF PREPAYMENT	% OF NATIONAL ELIGIBLE UNITS
I	43,931	5,333	1.47%	14,203	3.91%	19,536	5.37%	19,195	5.28%	4,016	1.10%	23,211	6.38%	1,184	0.33%
II	24,953	1,966	0.54%	500	0.14%	2,466	0.68%	19,303	5.31%	2,992	0.82%	22,295	6.13%	192	0.05%
III	53,419	15,305	4.21%	10,172	2.80%	25,477	7.01%	17,955	4.94%	9,041	2.49%	26,996	7.43%	946	0.26%
IV	55,545	7,733	2.13%	10,232	2.81%	17,956	4.94%	25,436	7.00%	11,350	3.12%	36,787	10.12%	804	0.22%
V	60,262	16,434	4.52%	4,770	1.31%	21,204	5.83%	31,061	8.54%	6,353	1.75%	37,414	10.29%	1,644	0.45%
VI	43,153	4,791	1.32%	16,000	4.40%	20,791	5.72%	10,698	2.94%	11,427	3.14%	22,125	6.09%	237	0.07%
VII	16,119	2,564	0.71%	1,471	0.40%	4,035	1.11%	9,612	2.64%	2,376	0.65%	11,988	3.30%	96	0.03%
VIII	12,068	1,315	0.36%	3,480	0.96%	4,795	1.32%	5,133	1.41%	1,651	0.45%	6,784	1.87%	489	0.13%
IX	38,770	27,838	7.66%	2,584	0.71%	30,422	8.37%	8,186	2.25%	106	0.03%	8,292	2.28%	56	0.02%
X	13,329	2,809	0.77%	4,587	1.26%	7,396	2.03%	4,337	1.19%	3,056	0.84%	7,393	2.03%	540	0.15%
NATIONAL	363,549	84,257	23.18%	70,017	19.26%	154,274	42.44%	150,816	41.48%	52,469	14.43%	203,285	55.92%	5,990	1.65%


GRAPH 5A

PERCENTAGE OF NATIONAL ELIGIBLE UNITS


GRAPH 5B

ELIGIBLE UNITS REGIONAL PROFILES

Senator **Cranston**. Thank you very much. Thanks for adhering to the time limit. I appreciate that very much.

So you can meet your other commitments today, I will be very brief in my questioning. The subcommittee may, however, as I indicated, submit written questions to you.

VOUCHERS FOR TENANTS

You indicate in your testimony that owners are most likely to prepay in rental markets that are particularly tight. You then note that the administration will be providing vouchers for tenants affected by prepayments and even acknowledge that the issue has been raised as to how vouchers can be used in tight markets.

Most serious observers are concerned the vouchers just don't work in tight markets. Isn't this just another effort to avoid coming to grips with the problem? That is, aren't you proposing only to advise displaced tenants to move to an apartment that we all know probably does not exist in their local area? What other alternatives have you been giving serious consideration by the administration and what have you done to assess the cost-effectiveness of such alternatives, if any?

Mr. **Demery**. Right now the vouchers have been a successful tool in helping provide some transitional assistance from projects where owners have opted out or have created through prepayment displacement of tenants. There have been very few projects and a very few number of units that have been so affected.

In 1985, there were only 248 units. In 1986, a little over 1,000. This year to date so far, only 298 units with section 8 contracts have opted out, and there the tenants received vouchers. We have not at this point received any hard data to indicate that the voucher has not been a useful tool in providing help for those tenants so affected.

Now, the use of vouchers doesn't necessarily require them to move. I mean, they could very easily rent in-place if they so chose. As to the big wave of prepayments that's going to be coming in the next couple years, I think, as your graphs indicate—I know that there has been a common perception that vouchers don't work in tight rental markets for a number of reasons. We've got representatives from Boston and Massachusetts sitting next to me. I think by everyone's definition, both the State of Massachusetts and the city of Boston could be considered to be a tight rental market. They have been able to use the vouchers to a moderately successful degree and I know that they are trying new initiatives to make the voucher program work even better.

I know New York has had some difficulties in the past implementing the Voucher Program in New York City, but I think that with us working together with the PHA's and the housing authorities and so on, I think that the Voucher Program will continue to improve in terms of acceptance, as well as their use.

If my optimism proves to be wrong, then I think that the Voucher Program and those kinds of assistance programs need to be reexamined to take into account those realities, and they will be.

Senator **Cranston**. Thank you very much.

GINNIE MAE AUCTION

Only one month ago, Mr. Demery, you were instrumental in halting an auction of mortgages that was planned by Ginnie Mae. As reported by the New York Times, you said you feared that if private investors bought the mortgages from the government rents might be raised "beyond the present tenants' ability to pay."

You then turned around and proceeded to propose an auction of HUD held mortgages, which sort of baffled us. I gather that's underway now. Serious observers advise us that both sales raised the very same issues.

So I'd like to ask what happened between the cancelation of the Ginnie Mae auction and the proposed June 2 and June 5 sales? How do you distinguish between those different sales? Did the administration change policy or did you change policy or what happened?

Mr. DEMERY. The quote from the New York Times that you just read I have no doubt as to the accuracy of the quote. I'm somewhat baffled as to the source of the quote, as I don't recall those words ever passing through my lips.

Second, the Ginnie Mae situation that occurred over a month ago, the issue that surrounded and dealt with the Ginnie Mae auction is a separate and distinct issue in my view than the sale of HUD held mortgages. Let me try and hopefully once and for all explain the difference.

The 236 and 221(d)(3) projects that were a part of the Ginnie Mae auction, where Ginnie Mae was the mortgagee were loans that within the next few years could be prepaid as their lock-out or lock-in provisions would expire.

I had been discussing with various committees of Congress and subcommittees of Congress ways by which to develop inducements for owners to consider extending voluntarily their lock-in provisions. Each of the inducements, for example, an increase in the rate of return, allowing secondary financing, an increase in the basis upon which the return could be taken—each of those inducements in my view could require a modification of the mortgage as the mortgage right now doesn't provide for those things.

What I wanted and what I discussed with Ginnie Mae and what Ginnie Mae agreed with me on, was that the mortgage documents before they would be given to Fannie Mae or whomever, as trustee, the documents, should be flexible enough to accommodate a modification of that type if the mortgagor and HUD voluntarily entered into an agreement that the mortgagee would then be required to accept.

That was the concern that I raised with respect to the Ginnie Mae sale. Those were fully insured loans that I didn't think had enough flexibility in them to accommodate many of the inducements that I've discussed in the past and will undoubtedly be discussed the balance of today.

The HUD held sale, which the first bid opening was 2 days ago, included loans that were previously insured that had gone into default where the Government had paid the claim and were for the most part unsubsidized loans.

Now we had a bid opening—there was a two-tier offering. The first offering was on a whole-loan basis to anyone and everyone that would be interested in one or more of the loans. That bid opening occurred on Tuesday. We received 31 responsive bids out of a total of 311 mortgages that were being offered up. We got a very good response in terms of the dollar amount. We got about an 83 percent recovery. We think that it's consistent with what we are trying to do with respect to reducing the deficit. The properties are not insured and for the most part, the overwhelming majority of those loans that were being sold through housing were basically unsubsidized § 221(d)(4), § 608, and § 207 type loans.

Senator CRANSTON. Thank you very much.

INVESTORS ENTER HOUSING SUBSIDY PROGRAMS

Some argue that investors enter into these housing subsidy programs in exchange for a reasonable return on their investment, essentially through tax benefits. These people argue that allowing owners to prepay and evict their low income tenants enables them to receive profits far in excess of what could reasonably have been anticipated at the beginning of their investment.

I'd like to ask how you assess that argument. What studies, if any, has HUD performed to learn what return investors are receiving on their investment and may receive in the event of prepayment? And if you haven't got such studies, would you be willing to make some?

Mr. DEMERY. We don't have such studies. I know Deane Ross is going to be testifying later and he has made a very successful career of acquiring and syndicating real estate, particularly low income real estate. And as I understand it, he can certainly correct me later, but as I understand the overwhelming majority of tax benefits in the way of "return" are in the first 5 years of ownership.

I think that, for example, deals that were done and syndicated beyond that 5-year window, for the most part, a prepayment 3 years hence or so from now I don't know that it would have necessarily the effect of any sort of a windfall additional benefit.

I don't have any studies to back that up, but I would certainly be willing to entertain conversations with those people in the industry that make their living that way to validate that premise or to disprove it, depending on what the situation is.

Senator CRANSTON. Thank you very much.

Mr. DEMERY. NHP is also active in that area and we have people we can bounce that idea off of.

Senator CRANSTON. Al.

Senator D'AMATO. Mr. Chairman, I would ask that I be permitted to submit a statement by Senator Heinz who's gone down to the floor as if read in its entirety.

Senator CRANSTON. Yes, that will appear in the record.

STATEMENT OF SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, thank you. I believe that this morning's hearing focuses on a very important topic. Preservation of our Nation's low-income housing stock is an issue that strikes at the very heart of our Federal housing policy. Simply stated, there are hundreds of thousands of tenants living in privately owned HUD-subsidized housing who, in the not too distant future, risk being displaced from their dwelling because their landlords feel it is no longer profitable to operate low-income housing.

I'm going to speak briefly about this issue this morning. But first, I would like to make a general observation. This morning's hearing marks a departure from what has sadly become standard operating procedure in the area of housing legislation. Too often in recent years, as the Chairman knows, the Congress waits until the brink of disaster to act on housing legislation, if it all. Indeed, for the last several years, we have not even had an authorization bill. Our Federal housing programs have limped along through annual appropriations bills year after year. I mean really limped—they've been cut by two-thirds since 1981.

But this morning, we have a chance to take a serious look at a problem so that we can devise an effective solution before it reaches crisis proportions.

Preservation of low-income housing rests largely on keeping in the housing stock those privately-owned properties whose contract terms are due to expire or whose mortgages are eligible or prepayment by the owner prior to end of the mortgage term. This is a very complex issue that will probably require a variety of policy tools to solve. As a member of the Senate Finance Committee, I know that the 1986 Tax Reform bill eliminated many incentives for developers to build and operate low-income housing. These changes, combined with an increasingly lucrative and tight housing market in many big cities, have led developers and investors to take a hard look at getting out of the low-income housing business. It just isn't as profitable as it used to be.

Partially, that's because the past few years have been good ones for the housing industry, and this is a positive development. But we cannot afford to ignore the increasing number of poor people who need affordable housing, particularly since the potential for profit through conversion of low-income housing is greatest in those cities with tight rental markets—Philadelphia, New York, Chicago—where the waiting lists for section 8 housing are longest.

The challenge before us is to craft a policy that provides the right mix of incentives and subsidies to keep these low-income housing units in the stock. This package will probably entail some tax relief, some rent adjustments, and perhaps some new and creative solutions beyond our traditional instruments. I don't pretend to have the answer to this problem at this time.

But I do know this. Over the years we've put programs in place that, although they have worked well up to a point, didn't contemplate the situation we're facing today—increasing numbers of low-income people, reduced tax incentives to house them, and a booming national housing market with increasingly attractive options for developers.

It's time we took a good hard look at this issue. And with the help of an excellent group of witnesses, that's what we're going to do this morning.

I look forward to working with all of you to develop legislation to protect our Nation's low income housing stock for those who really need it. Thank you.

Senator D'AMATO. Mr. Demery, I, too, share Senator Cranston's concern as it relates to the sale of the HUD mortgages because although they may not be directly assisted projects, I think we still have a stake as it relates to the tenants and the possible displacement of those tenants. And I am most concerned as I believe that unless we are very careful we are going to help precipitate and add to the crisis that exists and is growing as it relates to more and more people finding themselves with no place to live.

I would suggest that you undertake the kind of study that Senator Cranston has asked you about as it relates to the incomes that have been earned. I think you can do that with a degree of relative ease and go back and take a look at some of these projects and question some of the developers as to it.

Second, I think it is absolutely imperative that the coalition that is presently reviewing the situation of tenants possibly being forced out as people opt for prepayment—there's a group working right now on that—that you be in the forefront working with that coalition and in suggesting to the Congress the possible solutions and not just section 8 as a solution because as you have pointed out that's really basically a crisis-easing situation and in many cases the section 8 vouchers have a very difficult time—for example, in New York City—finding the housing resources necessary. Because, without that solution, then I think that there are some of us who feel very strongly that we will have to move to more permanentize the moratoriums and I would be inclined to do so.

Mr. DEMERY. If I may respond for a minute, HUD is definitely involved not only as a technical resource but also in an advisory capacity, and I have a very keen interest in the various study groups that are currently underway. There are two that I know about and there are probably several more that I don't know of that relate to this issue.

I think it's important that as these groups get together and develop information that there be some common thread between the findings of all of these groups and I have a personal interest in this subject and I do intend to be involved.

Now with respect to the mortgage sales, I didn't mention earlier and I should have, that notwithstanding the fact that the 311 loans that I talked about that housing was selling—that was to the effect that they were formerly unsubsidized for the most part—the tenant protections, the use agreements that are in place right now for those that are currently receiving section 8 through property disposition, purchase money mortgage or whatever, those go with the land. We have not just said let's just cash in our chips and let the people fend for themselves. We have taken great pains to make sure that use agreements and deed restrictions are in place so that the people in place are not displaced, they are not just booted out, they are not converted to a high-rise building.

Senator D'AMATO. That's important to underscore. That's very important.

Let me ask you, there are these task forces, for example, the Housing Partnership Task Force and the Council of Managing

Agents Task Force, those are two that are working as it relates to this problem, the problem of prepaid HUD loans and possible dislocation of tenants.

You just mentioned that in this one area that the tenants protections, use agreements, et cetera, were continued as it related to the mortgages. It would seem to me that along this same area that you should be working and that you should be suggesting possible legislative action, if necessary, to this committee. Wouldn't you deem that appropriate?

Mr. **Demery**. I'm not sure I understand your question.

Senator **D'Amato**. OK. Let me spell it out. If we are concerned about the problems that take place as it relates to the prepayment provisions, that if underlying that is the question of what takes place to tenants, now it would seem to me that what we have is a collision here where there are some within the administration who say, well, let's get paid and get out and we'll cut our obligation—OMB. All right? Would you agree with that?

Mr. **Demery**. We've never had conversations like that.

Senator **D'Amato**. Well, do you think OMB is worried about the tenants? They look at the balance sheet. You don't really believe they're worried about the tenants? Thomas, don't be afraid "big brother" is listening.

Mr. **Demery**. It's not a question of that. We've never had substantive conversations about their concern for the tenants.

Senator **D'Amato**. Tom, I am not suggesting that you have. But as a basic rule, OMB wouldn't care what's taking place with those tenants. I get a call from the director. They just don't care. Do you really think he cares? He's looking at the balance sheet. OK. In any event, that's my observation.

But that's not your position. That may be the administration position as it relates to getting additional dollars in and so they are not really opposed to this prepayment. They are coming from a philsophy, part of the administration, that this is terrific. Now as to what happens to the people, how many will be put out on the street, how many will get section 8's that they can't really utilize in the existing housing markets, that's not their concern. That's your job. That's really our job. But that is our concern.

TENANT PROTECTIONS

So it would seem to me that some of those tenant protections that exist now should be built into the law irrespective of the prepayment. Now that may indeed make those properties less valuable. It would make it less likely that people would look to prepay. But don't we have a basic obligation to those tenants? Do we have an obligation to the tenants or do we have it to the developer who's now looking to prepay?

Mr. **Demery**. Well, I think we have obligations to tenants. I think we have obligations to programs. I think we have obligations to congressional intent. I think we have obligations to owners.

Senator **D'Amato**. Well, it's my intent—let me suggest this to you and I'll start out now and a lot of developers may not be happy with what I'm going to suggest, but I'm suggesting to my staff that they get busy working on legislation that will guarantee to the tenants who are in these facilities that their rights be protected regardless of these conversions, that they have the same rent structure that they have at the present time, that at least those tenants who are there have those rights. I'm not saying that the apartment unit itself in perpetuity that those same rights flow, but at least the tenants who are in places—elderly women, families at 50 percent and below of the median income in those areas—by God, you know—and this is a conservative Republican—I want to tell you, that's not what we should be doing to enhance somebody's balance sheet on one side because now he says I should prepay this and the heck with the consequences that befall those families. That's not what we're about.

So if somebody wants to come in and say, well, I have a right to prepay this thing. I'm going to prepay it, fine. But he also has, I believe, certain obligations and we should see to it that there are obligations that flow and those obligations being protecting legitimate rights of those tenants who occupy those facilities and then if he wants to convert, fine.

Do you see anything inconsistent with that?

Mr. DEMERY. No, I don't disagree with that and if something like that were to occur I would hope that the methodology of payment would be the voucher.

Senator D'AMATO. Well, let me suggest this to you. I would hope that you could be of assistance at HUD in helping us to draft some legislation to protect tenants in those cases.

Mr. Chairman, I think that that should be an undertaking of this committee and I would hope that we could do it in a bipartisan fashion so that we don't get bogged down in a situation as to who takes credit or who doesn't take credit, or a Democratic or Republican initiative, but really an initiative that will protect the legitimate rights of these people who in many cases will find themselves—and we eventually as a Nation, we'll be placed in a terrible position of having these people placed out on the streets.

Mr. DEMERY. I would only add one footnote to that, Senator, that I would like to make sure that the owners' rights and contractual rights are also protected. I mean if, for example, at some point in the future there's going to be another program in whatever form, shape or whatever, that's going to involve the development or syndication or what have you of low income housing, I think developers are going to be taking a very keen and watchful eye as to how they have been treated in the past.

Senator D'AMATO. Let me give you one aside to that, and I understand that, but under what we've done in the new tax code, as practical matter, is say that there will not be—for example, in New York City, not one unit of rental housing for people of modest means, not one. So that becomes—don't worry about that unless we begin to address what we did on the tax bill.

Mr. DEMERY. It's all part of a package.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator CRANSTON. Thank you, Al. You brought up a matter that obviously we have to explore and we have to find a remedy and we will do that.

Senator Chafee.

Senator **Chafee**. Mr. Chairman, I, unfortunately, have to go to the floor because I've got a matter coming up now, but I've got a statement and I'm intensely interested in this and particularly the matter that Senator D'Amato pursued. I think that he's really onto something there and we've got a terrible problem and that looks like a possible solution to it. So I do hope that the subcommittee will work on it. Certainly I'll do everything I can to be helpful.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JOHN H. CHAFEE

Senator **Chafee**. Mr. Chairman, let me commend you for calling this hearing today on preservation of America's low income housing stock.

This issue has not had great public awareness, but its shadow will loom ever larger over the housing and the homeless questions in the months and years ahead.

The potential loss of up to 900,000 low income units by 1995, and even more in the decade thereafter, without significant expected replacement causes profound concern. And it matters just as much to a smaller state as to the larger ones, for each person or family displaced becomes a story of further hardship.

Accordingly, we must understand both the nature and ramifications of the problem, and the recommendations for its control. This hearing will be extremely helpful to achieve this goal. And then we must act.

Thank you. Mr. Chairman.

Senator **Cranston**. At this point, I have a statement from Senator Sasser that will be inserted in the record.

STATEMENT OF SENATOR JIM SASSER

Senator **Sasser**. Mr. Chairman, I am pleased that today this subcommittee will hear testimony addressing the issue of the preservation of the Nation's supply of low income housing.

There are no two ways about it—there is a mammoth housing problem facing America. Since 1970, the cost of housing has risen at a rate four times faster than have family incomes. And there are indications, as we will hear today, that there is a drastic shortage of low income housing developing.

We are facing a social and economic disaster. With a shrinking supply of low cost apartments, growing numbers of renters must pay a higher price, and a greater and greater percentage of their income for housing—forcing them to cut back on other basic human needs.

Our commitment to assisted housing has indeed been lacking: we have cut Federal housing subsidies from $30 billion to $8 billion in the last 6 years. Unfortunately, the end result of last year's tax reform bill will be even less available housing. And in the private sector, we are witnessing the rampant conversion of apartments to condominiums in many of our urban areas.

Now, today we will hear that prepayments of mortgages, on privately owned but federally subsidized housing projects, may cause the displacement of hundreds of thousands of low income tenants, in the very near future. Clearly, Congress must do everything it

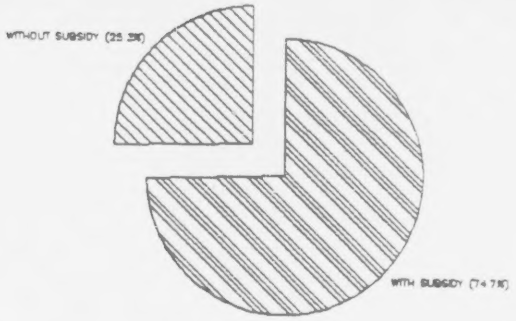
05-Mar-87

TABLE 6
PREPAYMENT SURVEY: TENANT-BASED SUBSIDY COMPARISON

REGION	PROJECTS WHICH ARE ELIGIBLE TO PREPAY					
	# OF PROJECTS	# OF UNITS (INCLUDES T-8 SUBSIDY)	# OF PROJECTS WITH TENANT-BASED SUBSIDIZED UNITS	TENANT-BASED PROJECTS (REGIONAL PERCENTAGES)	TOTAL TENANT-BASED SUBSIDIZED UNITS	TENANT-BASED UNITS (REGIONAL PERCENTAGES)
I	308	43,931	235	76.30%	18,432	41.96%
II	183	24,953	163	89.07%	19,147	76.73%
III	328	53,419	177	53.96%	16,833	31.51%
IV	527	55,545	384	72.87%	24,902	44.83%
V	482	60,262	372	77.18%	27,425	45.51%
VI	348	43,153	227	65.23%	13,171	30.52%
VII	160	16,124	121	75.63%	6,345	39.35%
VIII	195	12,068	186	95.38%	8,354	69.22%
IX	415	38,770	290	69.88%	19,329	49.86%
X	297	15,329	269	90.57%	9,768	63.72%
NATIONAL	3,243	363,554	2,424	74.75%	163,706	45.03%

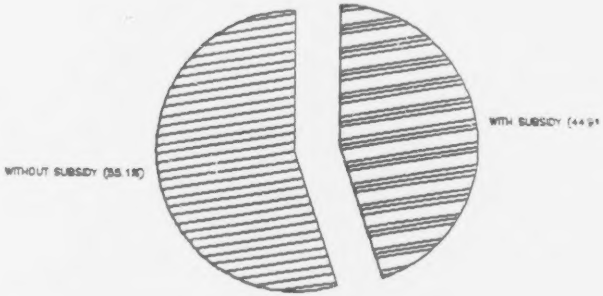
GRAPH 6A

TENANT—BASED SUB. IN ELIGIBLE PROJECTS



GRAPH 6B

TENANT—BASED SUBSIDY OF ELIGIBLE UNITS



Attachment B

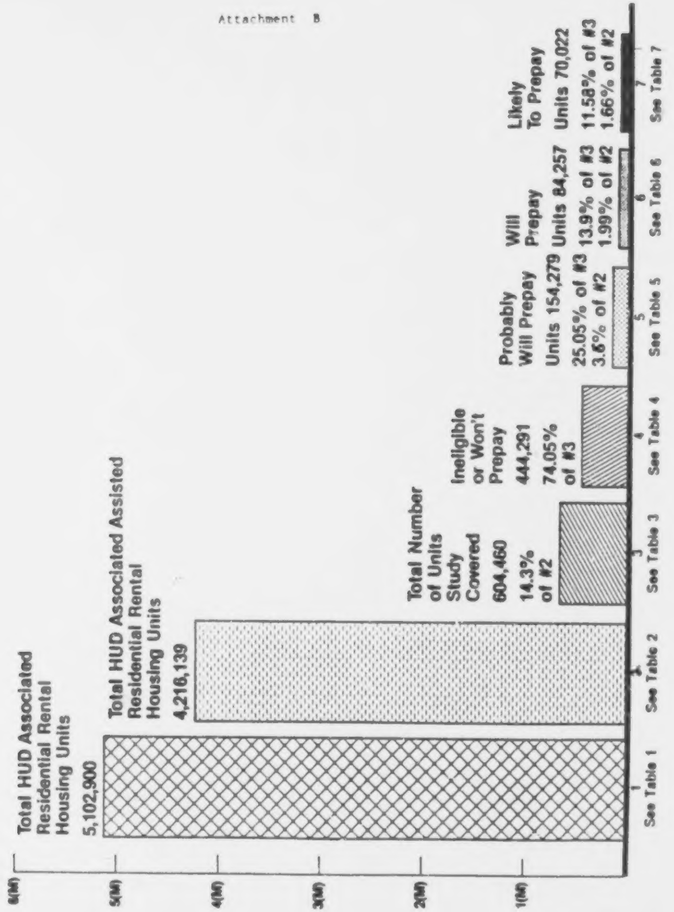


Table 1

Breakdown of Graph Entitled Total HUD Associated Residential Housing Units

(Excludes Single Family Insured)

1. HUD Insured and Held Unsubsidized Units. (Excluding Single Family)	886,761
Insured and HUD Held Section 236, 221(d)(3) BMIR 221(d)(3) MR R/S LMSA Projects	604,460
State Financed Section 236 Projects	117,627
Section 221(d)(4) Section 8 Insured and HUD Held	298,214
Non/Insured Section 8 Project Based	437,860
Section 202	204,828
Conventional Public Housing	1,227,057
Mod Rehab Section 8	364,198
Certificates	876,532
Vouchers	85,363
Total	5,102,900

Table 2
Breakdown of Graph Entitled
Total HUD Associated Residential Assisted Housing Units
Through 2/87

1. Insured and HUD Held Section 236, 221(d)(3) BMIR 221(d)(3) MR R/S LMSA Projects	604,460
2. State Financed Section 236 Projects	117,627
3. Section 221(d)(4) Section 8 Insured and HUD Held	298,214
4. Non/Insured Section 8 Project Based	437,860
5. Section 202	204,828
6. Conventional Public Housing	1,227,057
7. Mod Rehab Section 8	364,198
8. Certificates	876,532
9. Vouchers	85,363
Total	4,216,139

Table 3
Total Units
Prepayment Study Covered

All HUD Insured and HUD Held Units Assisted Under:

1. 221(d)(3) BMIR
2. 221(d)(3) MR R/S-LMSA
3. 236

Table 4
Ineligible or Won't Prepay

- Total of 444,291 Units
- Ineligible — 240,906 Units Were Non Profit at Time of Final Endorsement Therefore Must Get HUD Approval to Prepay 40 Year Term of the Mortgage
- Won't Prepay — 150,816 Units
- Unlikely Will Prepay — 52,469

Total 203,285

Table 5
Probable Prepays

- Likely Will Prepay — 70,022 Units
- Will Prepay — 84,257 Units

Total 154,279

- 25.05% of Study Units
- 3.6% of Total HUD Assisted Units

Table 6

- Will Prepay — 84,257
- 13.9% of Study Units
- 7.99% of Total Assisted Units

Table 7

- Likely to Prepay — 70,022 Units
- 11.58% of Study Units
- 1.66% of Total Assisted Units

can to ensure that the Nation's existing low income housing stock is preserved. This housing represents an inventory of units that would be far to costly to replace.

Mr. Chairman, I look forward to hearing the testimony of the distinguished witnesses you have assembled to educate us on this most serious problem. Thank you.

Senator **Cranston**. Thank you. Chic.

Senator **Hecht**. Thank you, Mr. Chairman.

I'm sorry I walked in late, but pursuing the comments of my colleague from New York and Mr. Demery, I feel that perhaps if we're going to continue this type of housing that the private sector has to do it and I agree with Mr. Demery that the man who put his money down the line years ago has his rights too.

Maybe we should go back to the tax code and look at that and perhaps change the tax code. Would you care to comment on that?

Senator **D'Amato**. Senator, I indicated that it's going to be, in my opinion, absolutely imperative that we do the kinds of studies and present the information to our colleagues on both Ways and Means and Finance in both bodies to get them to look at the devastation of the housing construction industry as it relates to rental housing due to I think changes in the tax code.

I could get into some specifics. I don't think we would want to do it right here, but I can simply say to you I have a letter from a constituent here that talks about 3,000 plus units that would have been built in New York on the 80-20 provision where 80 percent were market level and 20 percent were below for people of low and modest incomes, not one unit will be built this year as a result of those changes.

IMPACT OF TAX INCENTIVES

So, yes, we had better revisit the question as to tax incentives. But as it relates to this particular issue now in terms of prepayment, we had better also take a look at what will happen to hundreds of thousands of people, some who fall in the region of below 50 percent of the median income in their regions and if you think we have a problem now with homelessness, with high rents, you just begin to have some of these people without any protections or meaningful tenant protections and we are in deep trouble. So we'd better analyze that, look to see to it that those proper protections as it relates to those facilities be in place.

Senator **Hecht**. Well, there are only two places where we're going to get housing for these people. That's the private sector or Government. And I always feel that the private sector can do a much better job.

Senator **D'Amato**. Well, then maybe you would help sponsor because I am going to submit a comprehensive package of legislation as it relates to tax incentives that will include rapid depreciation for rental housing, investment tax credits, passive loss flow-throughs, rehabilitation tax credits, and tax-exempt bonds. Now those are areas that we have just about totally walked away from. We got into this whole big thing of what a wonderful tax code we're going to do for America and in doing that we had the tax-writing committees, et cetera, say, "Whoa, we're losing all this income." Well, they weren't losing income. You've now just stopped it. Nobody is doing anything as it relates to this whole industry. You put lots of people out of work who would be involved in the construction. And more importantly, you lose this housing.

Now we'd better wake up those committees. You know they're all locked-step and they've all said we do nothing unless it's revenue neutral. Well, okay, then you will have nothing done as it relates to this area of the private sector.

So we will be developing legislation that will look to the private sector. I share your view as it relates to the construction of new housing but if we're going to get the private sector to do it, you've got to give them the tax incentives to do it. You've got to make it possible for them to make money to do it. Is that such a bad thing in America? All of a sudden, I have my colleagues who generally represent a point of view for big business saying, "No, somehow that's not good. We believe"—this Treasury Department down here—"It's not good that you use tax incentives to bring people in." Well, they're just not going to invest then. If they can't make money in rental housing, they're not going to invest. So you're not going to have any rental housing. But maybe when we submit some of this legislation we could have your support.

Senator HECHT. I certainly would encourage that type of legislation rather than the other type of legislation.

Senator D'AMATO. Well, let me suggest this to you, that I will be moving very forcefully on seeing to it that we don't have several hundred thousand, as the projections are, tenants knocked out on the streets. I used to live in an apartment and I have grandparents who lived in Government assisted project and I hate to think of what would have happened to Grandma and Grandpa if all of a sudden the guy could have prepaid his apartment and then where are they? They had lots of family who could have taken them in, but in these days we don't have those kinds of situations and I hate to think of what happens to the mama and the papa and the seven kids in the poverty area who are thrown out and what takes place to them and we have nine people out on the streets and they're homeless.

I just say we'd better take a look at that.

Senator HECHT. Well, we've got to come up with a solution, not just take a look at it and the solution should be in the private sector.

Senator D'AMATO. Well, I'll tell you one thing. You'd better keep them from getting out on the streets and if it needs be that the moratorium should be extended, I want to tell you something, I don't really care what that study group does because I have some pretty well conceived ideas as to what's going to take place and it doesn't take study groups and if they can't come up with something, I'm for extending the moratorium and then coming up with a tenants' bill of rights.

EXTENSION OF LOCK-INS

Mr. DEMERY. Senator Hecht, we had—it's now June 5. At the end of March I testified before a House subcommittee on this issue and I think since March 25 where the results of our survey were made known I think there's been a lot of progress that's been made with respect to this issue and we can talk about revising the tax code and we can talk about a tenants' bill of rights, we can talk about legislation, but I think the most immediate and really the proper first place to look is in developing and discussing with owners of the property voluntary inducements and extensions of lock-ins to provide those protections. That's the easiest, that's the cleanest, and that's where the first step should be.

Now one of my big concerns is that if we start talking about legislation and start talking about making it more difficult for the private sector to be private, if we start talking about all kinds of restrictions, notice requirements and so on and so forth, you are taking away from me my ability as FHA Commissioner to negotiate with owners. And since my March testimony, I might add, I've had several people—Senator Cranston, mainly from California—who have come in and said:

> Look, I own 10,000 units. In the next few years, my lock-ins are going to expire. I don't want to throw old ladies and Senator D'Amato's grandmother out on the street. I want to talk about how we can extend this lock-in period.

Now since this issue has come up and dialog has started and it's starting now to generate its own momentum and there are study groups and there are all kinds of talk as to a lot of solutions, I think that it's probably good to have all the homework and the background work done, but I would like to give the private sector the opportunity to react and be creative and responsive to a moral and social problem that exists. It truly does exist.

They may legally prepay, but many of the large developers that I've talked to and even small developers—but the large ones have been particularly concerned and have come to me—they've said, "Look, we want to try and work this thing out. We don't want to get hamstrung and we don't think you want to be hamstrung either," and I don't. I've had conversations. I want to continue with the series of inducements I've mentioned. We're talking. We're dialogueing. Some may not be perfect. Some may be flawed. But I think we're making progress. It's not like we're talking to a loaf of bread out there that owns all these projects. These are people who understand reality.

And these hearings and House hearings and so on are certainly realities.

Senator HECHT. You make a lot of sense to me. I like what you say.

Mr. DEMERY. Good.

Senator CRANSTON. What incentives have you considered or offered?

Mr. DEMERY. Well, we've got quite a number that are active policies in effect or currently under consideration. Most of these are in effect.

Where we have been approached under prepayment under section 250(a), we have required that use agreements continue until the expiration of the lock-in period.

We have imposed use restrictions on the purchase of projects at foreclosure sales, for example. We have required extension of use restrictions for projects receiving flexible subsidy. We are right now discussing with a number of owners increasing the 6 percent distribution rate in exchange for increasing their lock-in provision.

We are talking about increasing the basis upon which their rate of return is computed. We are also talking about allowing secondary financing to allow for them to access their equity, which parenthetically, under the Ginnie Mae scenario, if it had been done without the flexibility, that was an option that could not have been considered.

We are requiring lock-in extensions for workout and mortgage modifications. We have had a lot of very interesting proposals come to us, again mainly from California because California seems to be the State that's most affected. New York generally is not because most of the 236 and D-3's are ineligible for prepayment because of their ownership characteristics. But in California, there are quite a number of them and it has the highest percentage of any State.

Generally, what owners are coming to us and discussing with us is they're saying,

> Look, we're not sure what Congress is going to do and we want to kind of be ahead of this wave on this thing. We understand the intent. We have no intentions of displacing people and throwing them out into the street and to the wolves or increasing the ranks of the homeless or whatever. What we would like to do is we would like to come up with a method by which we can protect the in-place eligible tenants and let us start our transition over time through vacancies, let us as units become vacant rerent them at market, and we will agree to extend for a period of time our lock-in provision to protect the existing tenants.

Now that's different than "Thou shalt not prepay." It's also different than "Throw them out on the street." And that seems to be where the conversation is headed right now.

Thus far, I've not been too encouraged in that regard because I don't understand all the ramifications and impacts of that kind of conversation, but we are continuing to dialog.

Senator CRANSTON. Well, thank you. I appreciate that outline of the various incentives and options that you have considered or attempted and I wish you would give us in writing a more detailed description of that.

Mr. DEMERY. I'd be happy to.

Senator CRANSTON. If there are no further questions, I thank you very much. We kept you longer than we expected to, but I think it was a productive exchange and I appreciate your presence.

Mr. DEMERY. Mr. Chairman, I want to thank you and the rest of the panel for accommodating my problem this morning. It's a nice problem. I'm going to my daughter's graduation, so thank you very much.

Senator CRANSTON. Congratulations. Thank you.

We will now go to our first panel. Our first witness is Marvin Siflinger, executive director of the Massachusetts Housing Finance Agency, to be followed by William C. Apgar, Jr., with the Joint Center for Housing Studies, Cambridge, MA; and then I want to welcome a Californian, Susan Peck, who is with the California Coalition for Rural Housing Project from Mill Valley, CA.

First, Marvin Siflinger.

STATEMENT OF MARVIN SIFLINGER, EXECUTIVE DIRECTOR, MASSACHUSETTS HOUSING FINANCE AGENCY, BOSTON, MA

Mr. SIFLINGER. Mr. Chairman, members of the committee, thank you for providing me the opportunity to address you on the critical issue of the potential loss of thousands of units of rental housing for low and moderate income persons as a result of expiring use restrictions on HUD assisted developments.

My name is Marvin Siflinger. As the chairman mentioned, I've been the executive director of the Massachusetts Housing Finance Agency since 1983. I am also a member of the Executive Committee of the Board of the Council of State Housing Agencies and CHSA represents 57 State housing finance agencies across the country.

Prior to MHFA, I served for more than 23 years with HUD. From 1976 to 1983, I was area manager of HUD's Boston office with responsibility during most of that time for five of the six New England States. During my tenure at HUD, I had direct, first-hand experience with the section 221(d)(3), 236, and section 8 programs.

PRESERVE EXISTING RENTAL HOUSING

Let me state at the outset that we share the basic objectives expressed by most national, State and local entities to preserve existing rental housing; to protect lower income residents; to recognize the rights of owners; and to focus our efforts on incentives rather than negative actions.

The issue before us today has been well stated and it relates to the 221(d)(3) and 236 programs which were created in the 1960's. They had 40 year mortgages with options that would permit owners to prepay the mortgage at the end of the 20th year. With prepayment, all restrictions relative to the continuation of the units as low and moderate income rental housing would expire and we are now at that critical 20-year point.

HUD has produced figures which at this point indicate that no more than 600,000 units are affected and that only 150,000 of these are likely to prepay their mortgage and result in the loss of low income rental units.

Frankly, we feel that the problem is far greater than this and that the effect will be felt across the country and not only in certain geographic areas where the housing markets are currently tight.

I'd like to address some of the assumptions that have been made by the Congressional Budget Office study and the initial studies that I've seen from HUD.

First, the HUD initial study indicates that 600,000 units are affected. The figures do not include the as yet undetermined number of section 8 assisted units which have the 5-year opt-out contract provisions. The issue of the Farmers Home, 190,000 units, has already been discussed. In addition to that, there are 115,000 housing finance agency section 236 units which the Congressional Budget Office believes will not prepay because of additional State restrictions.

Our experience does not support this CBO assumption. In Massachusetts, some 4,400 units of MHFA financed section 236 units have no additional restrictions and will be eligible for prepayment between 1990 and 1993.

Second, the initial HUD estimates that 150,000 of the 600,000 units are likely to prepay and result in the loss of rental units do not take into account certain other factors, the principal factor being that economically depressed areas today may well become the booming markets of tomorrow and conversion to condominiums or market rentals may indeed become attractive.

As an example, 6 to 10 years ago, who would have predicted the economic upturn, increased housing costs, and low vacancy rates in Massachusetts today? We would expect the same impact in the sunbelt and elsewhere as these States regain economic strength and lower income rental housing becomes a primary candidate for prepayment and conversion to condominiums.

For this reason, we believe it's a national problem which requires basically a Federal solution.

Third, if HUD's information on areas most likely to be affected by prepayments is accurate, Los Angeles, Baltimore, Seattle, Dallas, Philadelphia, Chicago, Boston, and Washington, DC, then frankly we would have serious concerns that the loss of rental units in these cities might disproportionately affect minorities.

My basic point is that we view the issue of prepayments and the loss of rental housing as having far greater potential impact than these initial HUD estimates.

Our concerns are compounded by the current levels of rental production for low and moderate income housing. There was a conscious decision in the 1980's here in Washington which virtually ended the Federal role in housing production. The States have attempted to respond with limited resources that they have available and have produced significant amounts of additional rental housing. But State production has not begun to meet the current needs and cities and towns across the country are facing this crisis.

In Massachusetts, for example, we have aggressively committed State resources to housing production to attempt to fill the gap created by the virtual termination of Federal assistance. For example, during the last 3 years the MHFA has financed 7,600 units of rental housing with State subsidy funds. The repayment of these loans after 15 years will be used to ensure continued availability for low income units. At the same time, however, we are faced with the potential prepayment of loans of some 7,800 units between 1990 and 1993. In spite of our efforts, we stand to lose ground instead of gaining ground.

RENTAL PRODUCTION CEASED

Now rental production, as the chairman indicated, has ceased for more than a year during the deliberations on tax reform. The 1986 Tax Act eliminated most traditional investor incentives and resulted in increased need for State subsidies to make these programs feasible.

HUD Assistant Secretary Tom Demery has acknowledged the Federal responsibility to low income residents in HUD assisted housing and has already responded to some of our suggestions in a positive way. It's our hope that he will continue to be willing to work with the States and with others to resolve this problem.

Mr. Chairman, I see that my time is up. In my written testimony I've included a number of the proposed solutions that many of us have been talking about, some of which Mr. Demery has discussed, others we believe require further discussion and we believe will be helpful.

Thank you.

[The complete prepared statement of Marvin Siflinger follows:]

TESTIMONY OF

MARVIN SIFLINGER
EXECUTIVE DIRECTOR
MASSACHUSETTS HOUSING FINANCE AGENCY

BEFORE
THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

June 5, 1987

Mr. Chairman, **Members of the Committee**. Thank you for providing me the opportunity to address you on the critical issue of the potential loss of thousands of units of rental housing for low and moderate income persons as a result of expiring use restrictions on HUD-assisted developments.

My name is Marvin Siflinger. I have been Executive Director of the Massachusetts Housing Finance Agency since 1983. Since its inception in 1970, the MHFA has provided below market rate financing for 60,000 rental units and 15,000 homeownership loans for lower income persons.

I also am a member of the Executive Committee of the Board of the Council of State Housing Agencies. CSHA represents 57 state housing finance agencies across the country.

Prior to MHFA, I served for more than 23 years with the Department of Housing and Urban Development. From 1976 to 1983, I was Area Manager of HUD's Boston Office with responsibility, during most of that time, for 5 of the 6 New England states. During my tenure at HUD, I had direct, first-hand experience with the Section 221(d)(3), 236 and Section 8 programs.

Let me state at the outset that we share the basic objectives expressed by most national, state and local entities in seeking:

- to preserve existing rental housing;
- to protect lower income residents;
- to recognize the rights of owners; and,
- to focus our efforts on incentives rather than negative actions.

The issue before us has to do with HUD's Section 221(d)(3) and 236 mortgage insurance programs which were created in the 1960's. They had 40 year mortgage terms with options which would permit owners to prepay the mortgage at the end of the 20th year. With prepayment, all restrictions relative to the continuation of the units as low and moderate income rental housing would expire. We are now at that 20 year point and are faced with a problem, the full dimensions of which have yet to be clearly defined. This is due in part to the difficulty in obtaining clear and consistent information on how many developments are likely to prepay and when.

I would like to address some of the basic assumptions made by HUD and the Congressional Budget Office (CBO) in studies they have done regarding the likelihood of prepayment of HUD mortgages at the end of 20 years and the loss of low-income rental units.

First - HUD assumes that only 600,000+ Section 221(d)(3) and Section 236 units are affected. Their figures do not include an as-yet undetermined number of Section 8-assisted units which have 5-year opt-out contract provisions. And, they do not include some 190,000 Farmers' Home units which could prepay today if it were not for the moratorium imposed by the Congress earlier this year. They also do not include another 115,000+ HFA-financed Section 236 units which the CBO believes will not prepay because of additional state restrictions. Our experience does not support the CBO assumption. Some 4,400 of MHFA-financed Section 236 units have no additional restrictions and will be eligible for prepayment between 1990 and 1993.

Second - HUD estimates that only 150,000 of the 600,000 units are likely to prepay and result in loss of rental units. HUD's estimate comes from recent surveys of HUD field offices and does not recognize the dynamics of economic change. Economically depressed areas today may well become the booming markets of tomorrow and conversion to condominiums or market rentals may become attractive. As an example, 6 to 10 years ago, who would have predicted the economic upturn, increased housing costs and low vacancy rates in Massachusetts today? We would expect the same impact in the sunbelt states as they regain economic strength and lower income rental housing becomes a primary candidate for prepayment and conversion to condominiums.

Third - If HUD's information on areas most likely to be affected by prepayments is accurate -- that is Los Angeles, Baltimore, Seattle, Dallas, Philadelphia, Chicago, Boston, Washington, D.C. -- then, we would have serious concerns that the loss of rental units in these cities might disproportionately affect minorities.

My basic point is that we view the issue of prepayments and the loss of rental housing as having far greater potential impact nationwide than HUD's estimates indicate. In fact, given the difficulty in obtaining accurate and reliable data, we are concerned that we might be dealing with only the tip of the iceberg.

Our concerns are compounded by current levels of rental housing production for low and moderate income persons. A conscious decision was made in Washington in the early '80's virtually to end the federal role in housing production. The states have attempted to respond with the limited resources available and some have produced significant amounts of additional rental housing. But state housing production has not begun to meet current needs and cities and towns across the country are confronting the problems of inadequately housed and homeless people.

Rental housing production ceased for more than a year during the deliberations on tax reform. The 1986 Tax Act eliminated most traditional investor incentives and resulted in increased need for state subsidies to make projects feasible. The bottom line is that states simply do not have the resources and cannot be expected to be able to deal with both production of new housing and preservation of existing units.

We believe that the federal government has a role to play in preserving existing housing resources. It is important to recognize that, even as the prepayment provisions were negotiated with developers and owners 20 years ago, the assumption was that the federal government would continue to produce replacement units for low and moderate income persons.

HUD Assistant Secretary Demery also has acknowledged a federal responsibility to lower income residents in HUD-assisted housing and has responded to some of our suggestions in a positive way. It is our hope that he will continue to be willing to work with the states to resolve this problem.

One of the proposed remedies -- the use of vouchers for persons displaced as a result of prepayments -- is not a solution in tight housing markets where the housing simply is not available.

Another proposed remedy -- the use of the low-income tax credits provided in the 1986 Tax Act -- has yet to be proved. Developers, investors and the marketplace in general are just beginning to understand how the credit might work. And, the credit is slated to end in 1989.

Senator CRANSTON. Thank you very much.
Mr. Apgar.

STATEMENT OF WILLIAM C. APGAR, JR., JOINT CENTER FOR HOUSING STUDIES OF MIT AND HARVARD UNIVERSITY, CAMBRIDGE, MA

Mr. APGAR. Thank you. Mr. Chairman, members of the committee, thank you for allowing me to participate in today's hearing.

My name is William Apgar. I'm associate professor at Harvard's Kennedy School of Government and associate director of the Joint Center for Housing Studies of Harvard and MIT.

I begin my written statement today by noting that America is increasingly becoming a Nation of housing "haves" and housing "have-nots." I make this statement for several reasons.

First, because I am constantly struck by the fact that despite 4 years of unexpectedly strong housing production, the housing situation of the Nation's poorest renters continues to deteriorate. Next, I feel that basic facts concerning the income of renter households and the rents they pay are not that well understood.

What are some of these important facts? Today, America's low income renters are particularly vulnerable to any cutback in housing assistance efforts. First, for more than 10 years, the median income of renters measured in real terms has been falling and lags the growth of median income of home owners. This is understandable. The Nation's renter population includes many of the Nation's most economically disadvantaged citizens.

INCOMES LAG—RENTS SOAR

Second, as the incomes of renters lag, rents again measured in real terms, soar. Real rents did fall off somewhat in the 1970's, but since 1981 real rents have increased by nearly 15 percent nationwide and now stand at their highest level in two decades.

In addition, these national trends mask considerable variation across regions and individual metropolitan areas. By our estimates, from 1981 to 1986, real rents moved up by close to 20 percent in the Northeast and more than 25 percent in the West.

If rent increases on average are large, my sense is they may understate the growth in rents and the availability of supply of units occupied by low income households. From 1974 to 1983, the number of low cost renter units—that is, units renting for less than $250 per month in real terms—declined by nearly 2 million units.

That units renting for less than $250 should drop out of the inventory makes a lot of sense. A $250 per month rent represents a significant payment for the growing number of households with incomes less than $10,000, but this $250 rent, nonetheless, is still not sufficient to cover the basic cost of operating and maintaining a rental unit. Our analysis suggests that units renting at $250 a month or less are still dropping out of the inventory at a substantial rate. This is the result of a dual process of either abandonment on the one hand or conversion to higher income occupancy on the other. While abandonment still continues in some areas, substantial reinvestment and upgrading occurs in others.

Symptomatic of this trend is the fact that after virtually no growth in real terms from 1970 to 1982, rental rehabilitation expenditures have more than doubled in the past 4 years. Growth in rental rehabilitation expenditures are particularly high in areas with the most rapid rent increases.

What do I conclude from these data? Well, despite high levels of new construction and equally high levels of housing rehabilitation expenditures, the supply of low cost rental housing continues to decline. The result is the continuing tightening of the low end of the rental market and the growing disparity between rents and real incomes of renter households. The growth of a permanent underclass of disadvantaged renters makes the job of providing decent housing for all more difficult.

Addressing these problems will require the concerted effort of all levels of government. In this effort, the Federal Government can take the lead. Congress should expand cash assistance programs to help offset the growing payments burden of low income renters. Congress should expand targeted rental rehabilitation and develop efforts to help stabilize the existing stock of privately owned low cost rental housing.

Let us not forget that of renter households with real incomes less than $10,000, roughly 75 percent of these renters live in nonsubsidized private rental housing units. We need to work vigorously to ensure that the existing stock of subsidized housing are not lost from the inventory. We need to develop a politically acceptable set of tax policies that will encourage once again the construction of affordable rental housing. Finally, we need to build on the innovative programming and experience developed by State and local housing agencies.

The problems facing the Nation's low income renters deserve such special attention and I'd be happy to answer questions concerning my full report during the question and answer period. Thank you.

[The complete prepared statement of William C. Apgar, Jr., follows:]

Other proposed remedies hold promise. The potential to capture the federal budget obligations from the "out years" on projects eligible to prepay could provide the incentives to extend the rental use restrictions on some of these developments.

The use of housing vouchers in some cases and the authority to convert unused vouchers and Section 8 certificates to project-based subsidies in other situations could protect many low-income residents.

HUD's release of the DeWilde "pool" funds for Section 236 developments could serve as an incentive to owners who would prefer to maintain their units as rental housing.

Financial incentives could include increases in HUD's allowed return on equity, owner access to residual reserves, refinancing of project mortgages, increases in Section 8 rents to cover reasonable operating costs -- as well as tax law changes such as the extension of the low-income credit beyond 1989 and forgiveness of capital gains tax upon sale in return for additional protections for low income residents.

This is not intended as an exhaustive list of possible remedies - rather, it is an indication of some of the approaches which could be taken in to address the problem.

We have no clear idea of the extent of the ultimate impact of prepayments on lower-income people. We have not begun to assess the related impacts of limited housing production nationwide, Section 8 contract expirations and the recent proposals to sell the mortgages on other HUD projects which also will be eligible to prepay during the next several years.

We are concerned - as we know you are. My presence here today is to underscore the need for all of us to work together to find a way to preserve as much as possible of the nation's existing low and moderate income housing resources and to stress the need for a federal solution to what we believe is certain to become a national problem.

THE DECLINING SUPPLY OF LOW COST RENTAL HOUSING

TESTIMONY PRESENTED TO THE

U. S. SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

JUNE 5, 1987

BY

WILLIAM C. APGAR, JR.

JOINT CENTER FOR HOUSING STUDIES

OF MIT AND HARVARD UNIVERSITY

THE DECLINING SUPPLY OF LOW COST RENTAL HOUSING

America is increasingly becoming a nation of housing haves and housing have nots. The nearly 55 million American households who own their homes came through recession of the early 1980s more or less intact. These current homeowners are now using accumulated home equity to tradeup to bigger or better homes, to finance improvements in their existing homes, or to save for their retirement years. The result is an unexpectedly strong and prolonged housing recovery, led by solid sales of new and existing single-family detached homes and record level expenditures on maintenance and repair activities.

As Congress continues its ongoing assessment of the appropriate federal role in housing, and reviews specific issues relating to the expiring federal contracts and use restrictions on existing subsidized dwelling units, care should be taken not to use the overall health of the housing industry as a barometer to measure the housing situation of the nation's low income renters. Income growth of the nation's renters continues to lag behind the income growth of homeowners. Despite four years of high housing construction activity and growing rental vacancies, real rents continue to move up sharply and now stand at their highest levels in over two decades. Moreover, rents levels for modest quality housing appear to have increased faster than rents of better quality housing.

As high and increasing rents take up ever larger shares of the incomes of renter households, saving the downpayment required to purchase a first home is an increasingly difficult undertaking. The result is a sharp decline in the rate of homeownership, especially among young households.

With homeownership a distant and unreachable goal, many low and moderate income households must compete for a shrinking supply of low cost housing. Close to 75 percent of all renter households with incomes less than $10,000 continue to live in privately owned, non-subsidized housing. These households seek to occupy a vanishing resource. Private housing at rents these families can afford continues to be either lost to abandonment or upgraded to serve higher income households. Over the period 1974 to 1983, the number of units renting for less than $250 per month in real terms declined by 2 million units.

Left to compete for a shrinking volume of low cost, privately owned apartments, growing numbers of low income renters must pay 30, 40, or even 50 percent of their income for housing. Even less fortunate are those families and individuals who are squeezed out of the housing market altogether and forced join the ranks of the homeless. These problems can only worsen in the future unless there is a concerted effort at all levels of government to:

1. preserve and expand the existing stock of subsidized rental housing;
2. halt the loss of privately owned, low cost rental housing; and to,
3. increase the purchasing power of low income families and individuals.

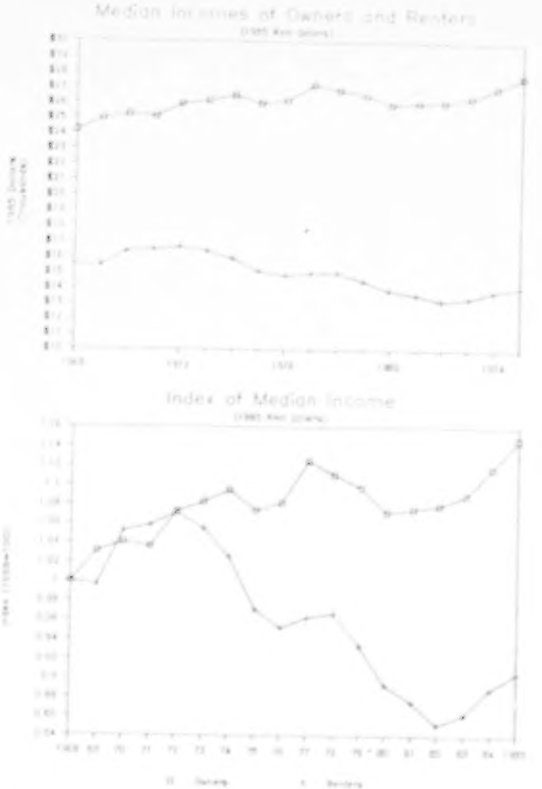
Absent such concerted action, there is every reason to project further deterioration in the housing situation of the nation's renter population and further increases the number of homeless individuals and families in the years ahead. To avoid this dismal outcome, public policies must come to better understand the basic factors that govern investment and disinvestment in the nation's rental housing inventory, and the forces that are generating the widening gap between the housing haves and the housing have-nots.

THE DIVERGING INCOMES OF OWNERS AND RENTERS

The threatened loss in subsidized units and the decline in the stock of low cost, non-subsidized, private rental housing comes at a time when low-income households, especially poor renters, are particularly vulnerable. Between 1974 and 1983, the median income of renters (measured in 1985 dollars) fell by 16 percent, from $15,900 to $13,400 (SEE FIGURE 1). The number of renter households with real incomes of less than $10,000 increased from 8.4 million in 1974 to 11.9 million in 1983.

It is understandable that the incomes of renters should lag behind inflation. The nation's renter population includes many of the nation's most economically disadvantaged citizens. Single parent families with children and households containing one or more elderly individual accounted for increasing shares of the low income renter group. By 1983, one third of all renter households with incomes less than $10,000 included children, while one quarter contained elderly individuals.

Figure 1



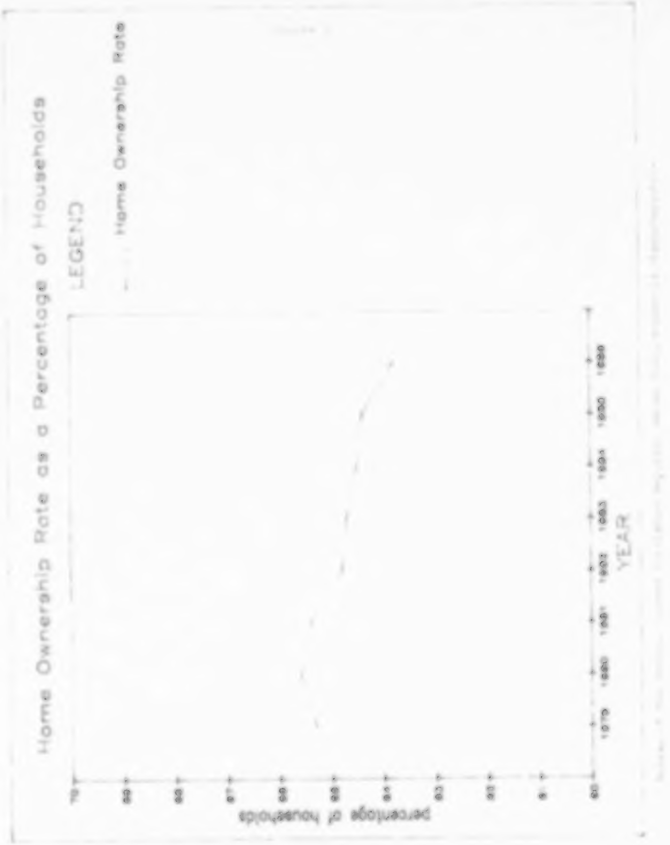
Sources: Joint Center for Housing Studies tabulations based on data provided by U.S. Bureau of the Census Annual Housing Survey and Current Population Reports for various years.

With the economic recovery of mid-1980s, the income of renters has moved up slightly in real terms. Consistently over the past twenty years, renter households have suffered sharp declines in income during periods of economic decline, cutbacks that have not been made up during subsequent periods of economic recovery. By 1985 (the most recent year for which data are available), the median income of renter households stood at $14,100, up from the 1983 figure of 13,400, but still well below the figures recorded in the late 1960s and early 1970s.

The failure of renter households to fully participate in periods of economic expansion results, then, in a widening gap between the incomes of owner households and the incomes of renter households. As indicated in lower panel of Figure 1, since 1972, the median income of renters has steadily fallen relative to the median income of owners. In 1972, the median income of homeowners was 55 percent greater than median renter income. By 1985, however, the median income of homeowners was 97 percent greater, or nearly double that of median renter household income.

RECENT TRENDS IN HOMEOWNERSHIP

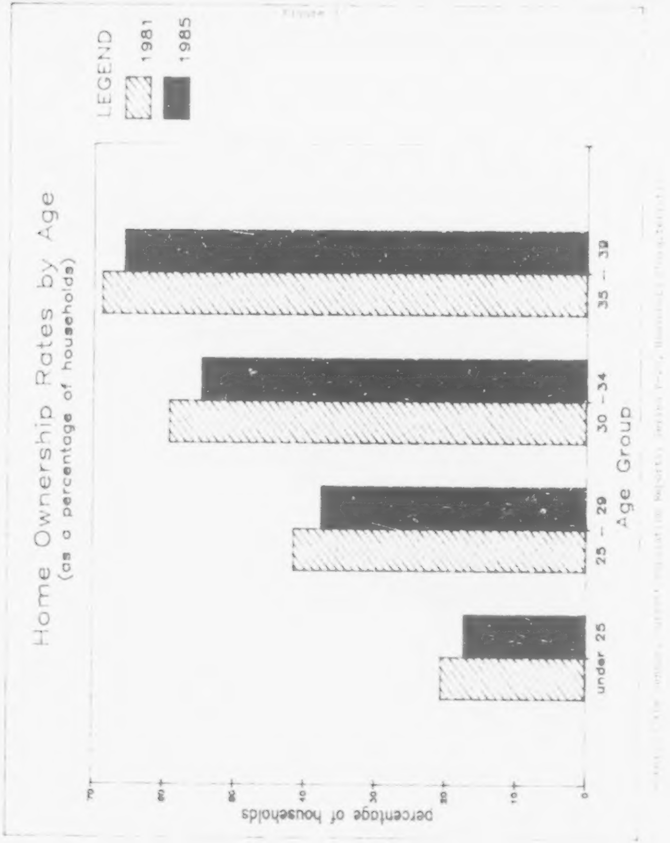
As the gap between the incomes of owners and renters widens, it is only natural that on average it is more difficult for renters to make the transition from renter to owner status. The result of this situation is clearly demonstrated in the Figure 2, which depicts recent trends in the rate of homeownership. During the period 1980 to 1986, the share of total households who owned their own home fell steadily from 65.6 percent to 63.8 percent, the most persistent decline in over 50 years.



While the decline in homeownership rate of 1.9 percentage points may seem modest, it is important to note that the aggregate rate combines the experience of households of all age groups. Many older households have owned their homes for years, and were therefore insulated from the adverse housing cost trends of recent years. For these households, rapidly inflating homes prices produced increased levels of wealth in terms of equity in their existing home.

Renter households, especially young renter households had no such buffer against the ravages of inflation. As indicated in Figure 3, much of the decline in homeownership has been concentrated among younger households. For households aged 25 to 29, the homeownership rate fell from 42 percent in 1981 to 37 percent in 1985. Households aged 30 to 35, and 35 to 39 suffered similarly sharp declines in the rate of homeownership.

The decline in homeownership is remarkable for several reasons. First, the decline in homeownership in the 1980s, has placed the nation's homeownership rate at its lowest level in 15 years. Next, the decline came at a time when demographic factors, that is, the aging of the baby boom into prime homebuying ages, would have pointed to sharp increases in homeownership rates. And finally, the decline in the rate of homeownership came during one of the most sustained and vigorous housing recoveries on record. The widening income gap between owners and renters makes it increasingly difficult for renter households to share in the benefits associated with an overall improvement in housing market conditions.

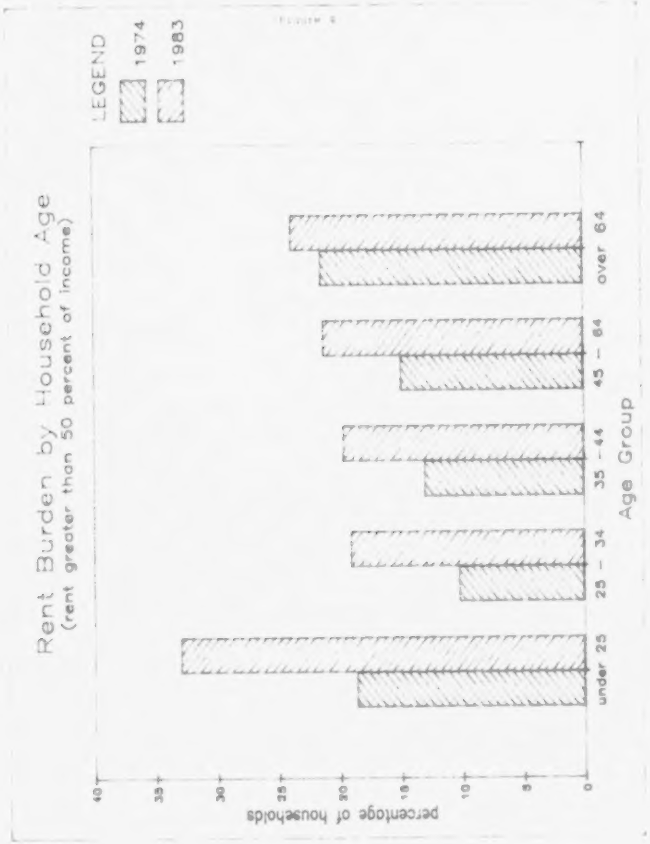


INCOMES AND RENTS: A GROWING DISPARITY

Over the past decade, the lagging real incomes have made the housing situation of renter households increasingly desperate. From 1974 to 1983, the proportion of renter households paying more than 35 percent of their income for rent increased from 25.1 percent to 37.2 percent. In absolute terms, the number of renter households so overburdened increased from 5.8 million in 1974 to 10.2 million in 1983. As should be expected, the nation's poorest households faced particularly severe payment burdens. In 1983, 7.7 million renter households with annual incomes less than $10,000 spent more than 35 percent of their income on rent.

The incidence of overpayment increased for a wide range of family types, with particularly sharp increases occurring among younger renter households. As indicated in Figure 4, the share of households paying more than 50 percent of their income for rent went up for all age groups, but particularly sharp increases were recorded for households aged 34 or less. Thus in 1974, approximately 10 percent of all renter households with head aged 25 to 34 paid in excess of 50 percent of their income for rent. By 1983, the share so burdened nearly doubled to 19 percent. (For a more complete discussion of the trends in rent burden see H. James Brown and John Yinger, "Homeownership and Housing Affordability in the United States," Joint Center for Housing Studies of MIT and Harvard University, August, 1986).

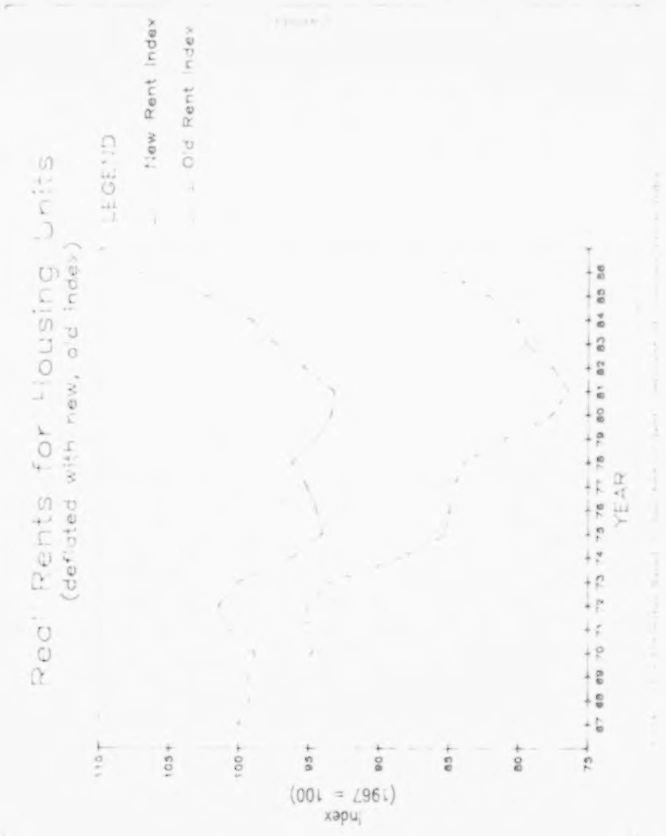
Figure 4



RECENT TRENDS IN REAL RENTS

The recent growth in real rents has gone largely unnoticed in housing policy circles. A casual assessment of the rental component of the Consumer Price Index seems to suggest that in the 1970s rents fell in real terms, and have yet to return to their previously high levels. When housing policy analysts studied the housing problems of the mid 1970s and early 1980s, it was common for them to examine CPI rent statistics and conclude that compared to the cost of building new housing, low rents made existing housing a bargain. (See "Old Rent Index" in Figure 5). Based on this analysis, housing assistance in the form of cash payments or demand side subsidies was presumed to be an inexpensive way of providing housing assistance.

Detailed analysis of rent trends now on-going by researchers at the Joint Center for Housing Studies of MIT and Harvard University demonstrates that the CPI presents a distorted view of recent rent trends. Building on previous work by Ira S. Lowry of the RAND Institute, the Joint Center analysis indicates that in 1986, real rents stand at their highest level in two decades. Though the CPI residential rent index is the best known measure of real rents, it has certain flaws. The CPI rent component is derived from rents on the same dwellings, which are resurveyed from year to year, with adjustments being made only for major changes in the quality of the dwelling units. As a result, minor changes attributable to depreciation are not picked up, nor are cost increases on utilities paid directly by the tenant. (For a more complete discussion see William C. Apgar,Jr., "Recent Trends in Housing Quality and Affordability," Joint Center for Housing Studies, 1985).



Properly measured, Joint Center estimates suggest that real rents move with the business cycle, falling off during periods of declining housing market activity and increasing during periods of cyclical increase. Real rents did fall off somewhat in the early 1970s, but since 1981 real rents have increased by nearly 15 percent nationwide and now stand at their highest levels in more than two decades. (See "New Rent Index" in Figure 5)

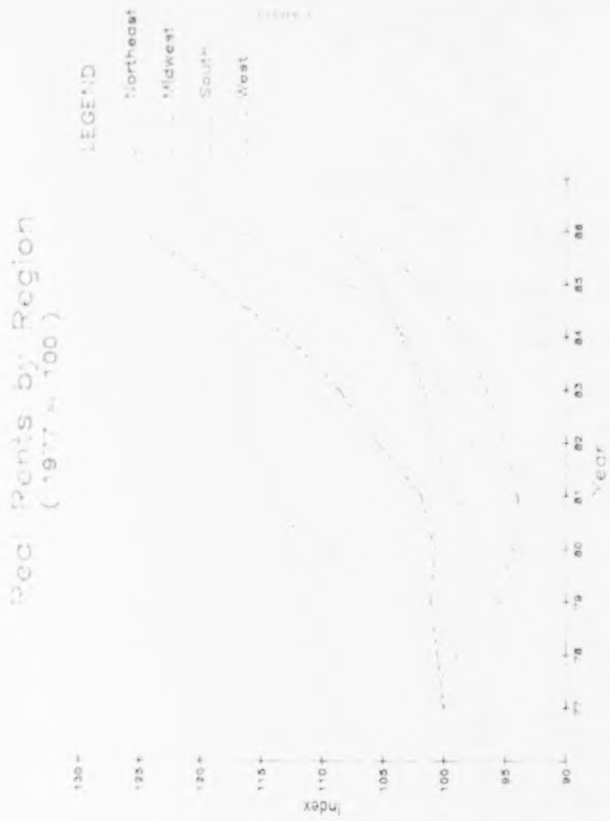
REGIONAL VARIATION IN RENT INCREASES

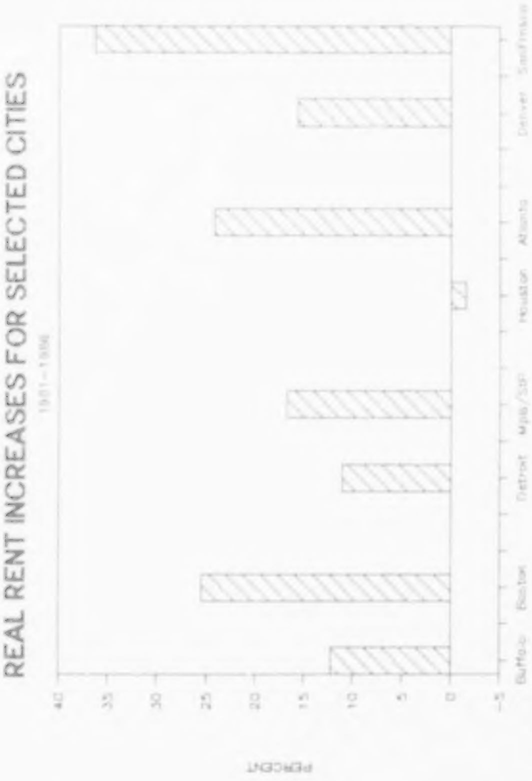
Increases or decreases in real rents result from the interplay of housing supply and demand forces in local housing markets across the country. Since markets are distinctly local by nature, simple explanations of observed national trends are somewhat precarious. With this caveat in mind, there are some generalizations that do serve to explain the broad pattern of rent trends. For much of the 1960s and early 1970s, the movement of population and jobs away from the core areas of nation's large metropolitan areas and the construction of a large number of subsidized rental units in core areas did serve to create somewhat of an excess supply of rental housing in many market areas. As a result, for much of this period, increases in real rents were modest, and disinvestment and abandonment of existing rental stock was high.

Despite continued high levels of construction, real rents -- that is rents adjusted for inflation of other goods and services -- have moved up sharply in the period 1981 to 1986. By our estimates real rents increased by 15 percent nationwide and now stand at their highest levels in more than two decades. As indicated in Figure 6, even sharper increases have been recorded in the Northeast and the West, areas of vigorous economic expansion. From 1981 to 1986, in the Northeast, real rents advanced by close to 20 percent, while in the West, real rents went up by nearly 25 percent.

In addition to these broad regional trends, the Joint Center is now assessing rent trends for selected metropolitan areas and different housing quality submarkets. As indicated in Figure 7, real rents in Boston, have increased by 25 percent over the period 1981 to 1986, while rent increases in Buffalo were a more modest 12 percent for the same period. In the West, real rents advanced in San Francisco by 36 percent, far in excess of the 16 percent increased recorded for Denver. Despite these variations, significant real rent increases were recorded in seven of the eight cities depicted in Figure 7. Only in Houston, a metropolitan area noted for substantial over-building of rental housing, have real rents held at or slightly below their 1981 levels.

Substantial variation in rent increases also exists within a given metropolitan area. Available data suggest that sharp as they have been, the growth in median rents understate the rent increases experienced at the low end of the market. New construction and major rehabilitation have added to housing supply at the upper end of the market, while housing disinvestment and abandonment continue to drain units away from the bottom. The result is a pattern for most market areas of modest rent increases for the best quality housing, but substantial rent increases at the low end of the market.

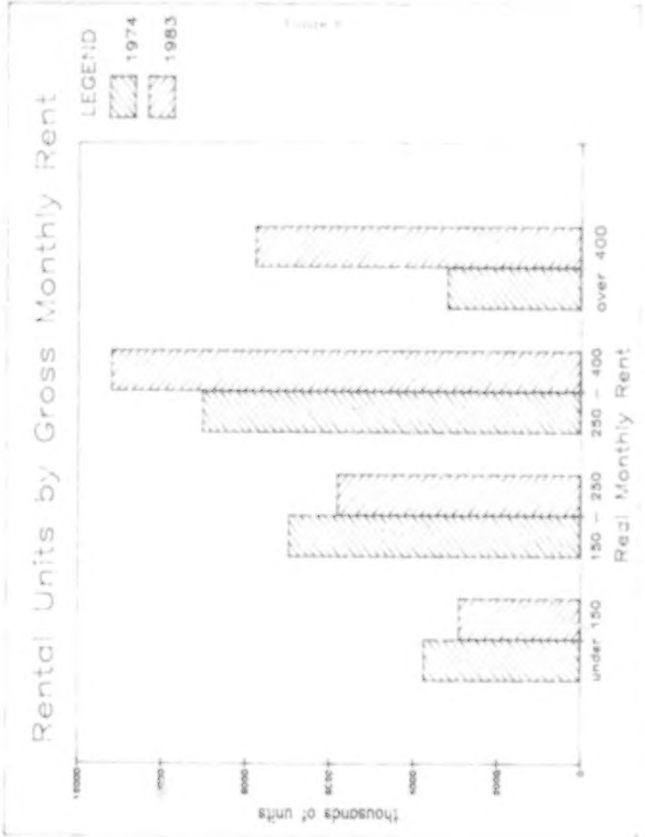




THE DECLINING SUPPLY OF LOW COST HOUSING

In retrospect, the fact that rents are increasing fastest at the low end of the spectrum is perfectly understandable. As noted earlier, rent levels in the 1970s were depressed. In technical terms, there was an excess supply of housing in some market areas. Many dwelling units were occupied in the 1970s and continue to be occupied today by households that are unable to pay a rent that is sufficient to cover the full costs of providing decent rental housing. For a household earning $10,000 a year, $250 a month is a high rental payment, an amount equal to 30 percent of income on an annual basis. Yet a rental payment of $250 per month is not sufficient in most housing market areas to cover the cost of operating and maintaining rental housing. A rent of $250 is simply inadequate to cover the costs of utilities, property tax, debt service and the like, let alone provide property owners with sufficient resources to maintain their dwelling units in good condition.

Consequently, as indicated in Figure 8, over the period 1974 to 1983 (again the most recent period for which data of this type are available) the number of rental units with real rents less than $250 per month declined by over two million units. The loss of these units involved two separate dynamics. Some of the low rent units present in 1974 continued to fall into disrepair and were abandoned and lost to the inventory. Again $250 per month is not sufficient to cover the costs of operation and maintenance. Other formerly low cost apartments, especially those in located stronger market areas like Boston, San Francisco, Atlanta, have been upgraded to serve higher income tenants.



It is difficult to measure the extent to which low cost housing is being lost to abandonment, on the one hand, or lost to revitalization and upgrading, on the other hand. Recent data on expenditures for rehabilitation suggest, however, that the extent of rental rehabilitation is significant. After virtually no growth in real terms from 1970 to 1982, rental rehabilitation expenditures (as measured by the U.S. Bureau of Census) more than doubled from 1982 to 1986. Rental rehab expenditures increased in all regions of the country, but particularly sharp percentage increases were recorded in the Northeast and the West. Apparently, the growth in real rents has made investment in private market rental rehab profitable again in many metropolitan areas, a fact that can only serve to further diminish the supply of low cost rental housing in the years ahead. (For detailed data on rental rehabilitation see Joint Center for Housing Studies, "Joint Center Research Update," March 28, 1987).

FUTURE POLICY DIRECTIONS

The current and continued health of the housing sector of the economy has served to deflect national attention away from the growing housing problems of the under-class of low-income renters and homeless families and individuals. With vacancies of new and existing rental housing at record levels, it may seem that there is no shortage of rental housing. With renovation and repair expenditures setting new record levels each year, it also may seem that the nation's inventory of existing units is being well maintained and preserved.

Yet as this paper has demonstrated, these comments bear little relationship to the realities the rental housing market. Despite high levels of new construction and equally high levels of housing rehab expenditures, the supply of low cost rental housing continues to decline. The result is continued tightening of the low end of the rental housing market, and growing disparity between real rents and the real incomes of renter households.

The growth of an under-class of disadvantaged renters makes the job of providing decent housing all the more difficult. Addressing these problems will require the concerted effort of all levels of government. In this effort, the federal government can take the lead by:

1. expanding cash assistance programs to help offset the growing payments burden problems of low income renter households;
2. expanding targeted rental rehabilitation efforts to help stabilize the existing stock of privately owned, low cost rental housing;
3. working vigorously to ensure that the existing stock of subsidized units are not lost from the inventory, either as a result of disinvestment and abandonment or conversion to higher income occupancy;
4. developing a politically acceptable set of tax policies to promote an appropriate set of incentives to encourage construction of affordable rental housing; and by,
5. building on the innovative programming and experience developed by state and local housing agencies.

The problems facing the nation's low income renters deserve such special attention.

Senator CRANSTON. Thank you very much.
Miss Peck.

STATEMENT OF SUSAN PECK, CALIFORNIA COALITION FOR RURAL HOUSING PROJECT, MILL VALLEY, CA

Ms. PECK. Mr. Chairman, I want to thank you and members of the subcommittee for the opportunity to testify on behalf of the California Coalition for Rural Housing Project. With the support of several foundations, the project has organized the California Anti-Displacement Project. The purpose of this project is to fully identify and measure the effects of section 515 prepayments and to work for National and State solutions to stop and mitigate the worst of them.

I'd like to start with the premise that should be acceptable to all—that is, the Federal Government's purpose in financing section 515 rental housing development is to assure that the housing built is provided to low and moderate income tenants at affordable rents.

Tenants are at the heart of the section 515 program. Therefore, it cannot be the role of the Federal Government, expressed or otherwise, to serve the financial interest of the project owners at the expense of the tenants.

Unfortunately, this is not the way the section 515 program is being interpreted. In California alone, prepayments have occurred on 37 Farmers Home projects containing 1,256 units. This amounts to about 20 percent of all section 515 prepayments nationwide. We have already lost 22 percent of Farmers Home's rental housing projects in California that are eligible for unrestricted prepayment simply because they were financed before December 21, 1979.

Nationwide, approximately 192,000 units of section 515 were financed prior to December 21, 1979. This accounts for 52 percent of all section 515 units financed since the program began in 1963.

FEDERAL GOVERNMENT SPENT BILLIONS FOR CONSTRUCTION

Let me emphasize here that the Federal Government has paid dearly for rural rental units. Over $3.3 billion was loaned to finance their construction. I'd like to add that this amount needs to be added to the Federal tax revenues that have been lost because of tax shelters created in the name of private investor participation in the section 515 program.

When these projects convert, let's not bemoan too much the owner's claim of economic hardship in operating subsidized housing under Farmers Home's rules and regulations. Instead, let us recognize the fantastic financial opportunities which were created for these owners through our tax system.

Let's also look at what it would take to replace these units. In 1979, the average section 515 rental unit cost about $17,000. In 1985, that same unit cost about $32,000. During that same period of time, section 515's budget went from $869.5 million down to $652 million, or a 23 percent drop in the budget for section 515. Were the entire pre-1979 financed stock converted, it would take $61.4 billion to replace those units using the 1985 building costs.

Numbers, of course, do not convey the full story. There are people here that are involved, people who were lured to these projects by affordable rents and a decent living environment. Through my testimony I'd like to introduce you to a few of the victims of some very bad public policy.

Tenants of the 40-unit Jamestown apartments in the Sierra foothills of California were notified in late May 1986 that the apartment owners had prepaid their Farmers Home loan and were increasing rents.

DISPLACEMENT VICTIMS

For Patsy Hammel, who suffers from osteoporosis and arthritis and who at the time was in a cast and unable to walk, the increase brought her rent up from the subsidized level of $70 per month to $248, more than triple what she was paying. At the time, Ms. Hammel was receiving $533 a month in Supplemental Security Income; her new rent would have amounted to 50 percent of her small income. Ms. Hammel now lives in a rest home at a great distance from Jamestown, CA and the costs that's incurred by the Government for her board and care probably greatly exceeds the subsidy that Farmers Home was paying on her rent.

Her neighbor, Joyce Silveira, with terminal cancer, now lives in a small trailer. At the time of the rent increase, she lost 15 pounds just worrying about the consequences of finding housing also on $533 a month income. Efforts to obtain section 8 certificates for Ms. Silveira and the other tenants were rebuked by HUD, although it had earlier that year issued emergency vouchers to flood victims in the neighboring counties.

Much of our information about tenants has been reported in the local newspapers and I would like to submit a lot of those newsclippings for the record. But for the tenants of the Sunset Apartments in Rocklin, CA, we know something about them by some declarations in a lawsuit that they filed against Farmers Home.

Teresa Bradley, a mother of a 7 year old who needs and now receives special assistance in a local school, and a 4 month old with a birth defect that's being treated by local doctors, her rent was increased from $88 to $400 a month.

There's Agnes Kelley, a 62 year old widow, who moved to Sunset Apartments 1½ years before the lawsuit was filed, and after her other subsidized housing was lost to her. It took her several years to get into Sunset Apartments because of the long waiting list and now she is being asked to move away from friends and family who take her to her doctor, store and other places she needs to be.

I just want to emphasize—and I will do this very quickly—that the problems that I'm describing are not unique to California. Farmers Home rural rental housing loans have been prepaid in almost every State and in fact four States appear to have more initial and subsequent prepaid loans than California. They include Iowa, North Carolina, Texas, and Wisconsin.

And the problem of displacement is not unique to California either. We have evidence of tenants being displaced in Washington, North Dakota, Vermont, and Minnesota.

We are faced with a national problem. We need a national solution. We have some recommendations on what might be done and we would also like to submit that as part of the testimony prepared by the National Rural Housing Coalition. I'd be glad to answer any questions.

[The complete prepared statement of Susan Peck follows:]

California Coalition For **Rural Housing**
Project

STATEMENT OF THE CALIFORNIA COALITION FOR RURAL HOUSING PROJECT BEFORE THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

June 5, 1987

Susan Peck
CALIFORNIA COALITION FOR RURAL HOUSING
1050 Redwood Highway
Mill Valley,California 94941

California Coalition For Rural Housing Project

Mr. Chairman, I want to thank you and members of the Subcommittee for the opportunity to testify on behalf of the California Coalition for Rural Housing Project.

The California Coalition for Rural Housing Project (Project) is a California-based nonprofit corporation organized to promote, improve and preserve affordable housing for low-income rural residents in California. With the support of several foundations, the Project has organized the California Anti-Displacement Project. The purpose of this project is to fully identify and measure the effects of Section 515 prepayments and to work for national and state solutions to stop and mitigate the worst of them.

We are here today because we have found that there is an urgent need for national legislation that would put an end to the conversion of all federally subsidized housing and would protect low-income persons and families from the displacement due to project conversions to higher income uses. Regrettably --- and often tragically --- thousands of low-income tenants in California and elsewhere around the Nation already have suffered the worst effects of short-sighted public policy.

Before describing what has occurred in rural California and rural America as a result of Farmers Home Administration (FmHA) Section 515 prepayments, let me start with a premise that should be acceptable to all, which is: the federal government's purpose in financing Section 515 rental housing developments is to assure that the housing built is provided to low-and moderate-income tenants at affordable rents. Tenants are at the heart of the Section 515 program. Therefore, it cannot be the role of the federal government, expressed or otherwise, to serve the financial interests of the project owners at the expense of the tenants. I'm sure as public policy makers you will agree with this simple premise, yet this is not the way the Section 515 program is being interpreted.

In California alone, prepayments have occurred on 37 FmHA subsidized projects containing 1256 units. This amounts to about 20% of all Section 515 prepayments nationwide. In fact, we have already lost 22% of the FmHA rental housing projects in

California that are eligible for unrestricted prepayment simply because they were financed before December 21, 1979. Seventy-eight percent (78%) of the loss occurred in the two year period of 1984 through 1986, when a temporary moratorium on prepayments was authorized in the federal Continuing Resolution. In California, there are 6260 units in 137 projects that remain eligible for prepayment at any time.

While our data is not exhaustive, it appears that most of the recently prepaid loans were approximately 10 years old. We suspect that this is due to the fact that owners of these projects had exhausted the lucrative tax shelters that were available to them as a result of their sponsorship of low-income, subsidized housing. It also suggests a frightening pattern for the near future should the moratorium be lifted and no federal legislation is in place to inhibit prepayments: the conversion of low-income housing to higher income uses, the accelerated loss of housing stock that is not being replaced and, worst of all, the displacement of poor people, the elderly and disabled, single parent households and minority families.

Nationwide, approximately 192,000 units of Section 515 were financed prior to December, 1979. This accounts for 52% of all Section 515 units financed since the program began in 1963. In the absence of new legislation, these units could be removed from the low-income housing stock at the will of their owners with only 60 days´ notice to Farmers Home Administration. Let me emphasize here that the federal government has paid dearly for these units: over $3.3 billion was loaned to finance their construction. We must add to this amount the federal tax revenues lost because of tax shelters created in the name of private investor participation in the Section 515 program. When these projects convert, let´s not bemoan too much the owner´s claim of "economic hardship" in operating subsidized housing under FmHA´s rules and regulations; instead, let us recognize the fantastic financial opportunities which were created for these owners through our tax system.

Let´s also look at what it would take to replace these units: in 1979, the average Section 515 rental unit cost about $17,000; in 1985, that same unit cost about $32,000 (for 1987, the estimate is $34,000). During that same period the Section 515 budget went from $869.5 million in actual expenditures to $652.3 million. Were the entire pre-1979 financed stock converted, it would take $61.4 billion, using 1985 building costs, to replace the lost units. Who will pay that price? And why should these units be lost at all?

Numbers, of course, do not tell the full story. While they convey the magnitude of the problem, they do not relate what has happened to the people who were lured to these projects by affordable rents and a decent living environment. Through my testimony, I´d like to introduce you to a few of the victims of some very bad public policy.

Tenants of the 40 unit Jamestown Apartments in the Sierra foothill town of Jamestown, California, were notified in late May, 1986, that the apartment owners had prepaid their FmHA loan and were increasing rents. For Patsy Hammel, who suffers from osteoporosis and arthritis and who at the time was in a cast and unable to walk, the increase brought her rent up from the subsidized level of $70/month to $248, more than triple what she was paying. At the time, Ms. Hammel was receiving $533 a month in Supplemental Security Income; her new rent would have amounted to 50% of her small income. Ms. Hammel now lives in a rest home, since affordable housing on the ground floor and near her doctors was not available. Since no rest homes exist in the Jamestown area, Ms. Hammel lives at a distance from her familiar surroundings. The cost now incurred by government for her board and care probably greatly exceeds the subsidy FmHA provided for her rent.

Patsy Hammel shared the rental complex with low-income families, senior citizens, other disabled persons, single parents on welfare and 7 clients of the WATCH independent living program for the mentally retarded. Her neighbor, Joyce Silveira, with terminal cancer, now lives in a small trailer; at the time of the rent increase, she lost 15 pounds just worrying about the consequences of finding housing on $533 monthly income. Efforts to obtain Section 8 certificates for Ms. Silveira and the other tenants were rebuked by HUD, although it had earlier that year issued emergency vouchers to flood victims in the neighboring counties.

Another neighbor, Martha Simms, an asthmatic, was evicted after refusing to pay a $240 increase in rent. Her "alternative" housing is a small unit in a neighboring city, where she pays about 60% of her income for rent. Another woman went to live with her grandmother, then she moved in with her former husband who had physically abused her in the past. One family moved to a shelter, which has since closed, and the family hasn´t been located since. Perhaps one silver-lining is the proposed development of a triplex on donated land for the members of the independent living program.

William Long was 86 years old when he was notified that the 41 unit apartment complex he occupied in Sonoma, California, was being prepaid and that his rent would increase from $198 to $450. He is a Navy veteran and confined to a wheelchair. At the time the prepayment was revealed, Village Green apartments for seniors had a 200person waiting list.

This proposed conversion caught the City of Sonoma by surprise; when the project was first proposed, the City secured a $60,000 grant to aid the development assuming that the project would remain low-income for at least 10 years. When confronted with conversion after 7 years, the City Manager was quoted in a local paper as saying that the partners must have "used all the tax depreciation value out of the project" and will convert units to market rate "to increase their profits". Unsuccessful negotiations ensued to obtain Section 8 certificates for Village Green tenants thereby delaying the actual prepayment. This loan prepayment is now pending the expiration of the moratorium.

Much of our information about tenants has been reported in local newspapers, and I would like to submit many of these newsclippings to you for the record. For the tenants of Sunset Apartments in Rocklin, California, however, we know more about them from the declarations they made as part of a lawsuit filed against the Farmers Home Administration to halt the prepayment of Sunset III, the final 48 units remaining after the prepayment of Sunset I and II, containing 56 units. Interestingly, the owners of this project, both before and after prepayment, are basically the same owners we find in Jamestown and Elk Grove where units also were lost to prepayment.

The intent of the owners, as reported in the newspapers, was to convert the units into conventional rentals, replete with a swimming pool, dishwashers, and market rate rents. Legal services attorneys were able to obtain a preliminary injunction in August, 1986, stopping the prepayment and allowing the tenants to remain in their units and to continue receiving rental assistance where applicable. FmHA is appealing the preliminary order, basically on behalf of the owners who now claim economic hardship. It is not surprising, however, that the owners are losing $28,000 a month rent, based on their new, conventional loan for Sunset I and II: they refuse to accept any of the former tenants back at the pre-conversion rents, and under the court order cannot rent to anyone at the higher rents.

Who are the victims here? Teresa Bradley, mother of a 7 year old who needs and now receives special assistance in the local school, and a 4 month old baby who has a birth defect treated by a local doctor and which will require future surgery. Her rent was scheduled to increase form $88 to $400. The waiting list for other subsidized housing has been closed. Debra Gillanders is a mother of a visually handicapped child who is enrolled in a special county program not available elsewhere. The rent increase to $400 would amount to half her income.

Patricia Benscoter, mother of a 4 year old, tried to find other housing. What she found was a one room apartment for $310 per month, plus a [illegible]50 deposit. The first month's payment would have been $770. Another apartment would have cost her $840 to move in. Roseville Gardens had a one to two year waiting list. Another mother found that some one bedroom apartments not only were too expensive, but the owners wouldn't rent the apartment to a mother and her child. Then there is Agnes Kelley, a 62 year old widow, who moved to Sunset Apartments 1-1/2 years before the lawsuit was filed and after her former rental housing was sold. It had taken her several years to get into Sunset Apartments because of a long waiting list. With heart problems, high blood pressure and arthritis, Mrs. Kelley needs the assistance of her children in Rocklin to transport her to the doctor, store and other places. Mrs. Kelly says that moving out of the area would create a "terrible hardship" on her which she doesn't believe she could handle.

These victims are rural, low-income people. But what is happening in rural California is only the tip of the iceberg. Section 8 "opt-outs", and prepayments of Section 221 (d) (3) and Section 236 projects, could leave several million people homeless. Some notable examples have already occurred in California, in my home county of Marin where low-income, mostly minority tenants were displaced when the new owner of Richardson Highlands refused to continue with the Section 8 subsidies still available to the project. The project owner, a major realty management firm in Chicago, continues to benefit from the long term, low-interest financing of the project, yet refused to accept rent vouchers to enable the formerly subsidized tenants to pay as high a rent as the unsubsidized tenants.

In Fremont, California, where Victoria Gardens, a 75 unit project for the elderly, is located, the City Council, the Department of Housing and Urban Development (HUD) and Congressman Don Edwards worked out a one year delay in tenant rent increases resulting from the owner "opting out" of the Section 8 program. HUD agreed to pay the higher rents for one year. This buys tenants like 65 year old Mary Simms some breathing time, but continues the tension and fear that can and does contribute to ill health.

Frankly, we doubt that the full extent of the hardship and suffering endured by these tenants and others will ever be documented. The General Accounting Office, which is studying the scope of displacement caused by Section 515 prepayments, has advised us that it simply cannot locate many of the tenants who resided in projects that were prepaid as recently as 1986.

We are aware that not every tenant who has resided in an FmHA project has been displaced as a result of a prepayment. In some cases rent subsidies continued because they were provided by the Department of Housing and Urban Development (HUD) under the Section 8 program. In other cases intervention by units of local government, housing officials, or members of the state's Congressional delegation have brought help in the form of Housing Vouchers, Section 8 Existing Certificates, or, as in one case, short-term direct grants from public and private sources.

These remedies are inadequate and unreliable because they are not institutionalized. Displaced tenants have no place to go and no assurance that they will be housed in decent, safe and sanitary or affordable housing. Even those tenants who reside in Section 8 assisted housing have no assurance that the owners of those projects will not opt out of their contract at the next available opportunity. HUD, also, cannot be relied upon because, among other reasons, it does not have an inexhaustible supply of Section 8 Certificates or Vouchers. Moreover, many of these remedies simply divert already very limited resources that were intended to expand the supply of subsidized housing and assist people who were not previously assisted. In short, prepayments cause a shameful waste of human and financial resources.

It is important to emphasize that the problems we have described are not unique to California. FmHA rural rental housing loans have been prepaid in every state except possibly Rhode Island and Delaware. In fact, four states appear to have more initial and subsequent prepaid loans than California: Iowa, North Carolina, Texas, and Wisconsin. Nor is the problem of displacement unique to our state. We have evidence that tenants are being displaced from projects in Washington, North Dakota, Vermont and Minnesota.

We are faced with a national problem, and we need a national solution that first and foremost protects the tenants for whom the Section 515 -- and the HUD programs -- are intended.

The California Coalition for Rural Housing Project would be remiss in not mentioning the tremendous debt we owe members of the California Congressional delegation, first in obtaining the moratorium on Section 515 prepayments, then in working toward a legislative, long-term solution to the prepayment/displacement issue. The eviction of the poor and disabled from the Jamestown Apartments was a terrible blow to Congressman Richard Lehman who had struggled to obtain subsidies to keep the tenants in their homes. He vowed to protect tenants in other projects and with the aid of Congressman Vic Fazio and their House colleagues, introduced the Section 515 moratorium. It was spearheaded in the Senate by our esteemed Chairman, Senator Alan Cranston, and by California's Senator Pete Wilson.

The moratorium bought time; we now must agree on solutions. H.R. 4 contains hard won provisions dealing directly with the Section 515 prepayment issue, as well as prepayments in HUD projects and Section 8 opt-outs. The National Low-Income Housing Coalition (NLIHC) will present its recommendations at today's hearing. As a member of NLIHC, our Coalition endorses its recommendations.

For the Section 515 program specifically, I would like to incorporate as part of my remarks written testimony prepared by the National Rural Housing Coalition (NRHC), which I would be glad to summarize for the subcommittee if you would so desire.

Once again, our sincere thanks for this important opportunity to speak with you on a subject we consider to be housing's most significant public policy issue for the remainder of this century.

Prepared by:
California Coalition for
Rural Housing Project

April 1987

FMHA SECTION 515 RURAL RENTAL HOUSING PROJECTS
SUBJECT TO EARLY PREPAYMENT
BY CONGRESSIONAL DISTRICT

LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 1					
BOSCO (D)	Seabreeze Apartments	Crescent City	Del Norte	56	
	Totem Villa Apartments	Crescent City	Del Norte	36	
	Mountain View Village	Fortuna	Humboldt	48	
	Orchard Manor Apartments	Ukiah	Mendocino	64	
	River Gardens	Fort Bragg	Mendocino	48	
	Cypress Ridge	Fort Bragg	Mendocino	42	
	Holly Heights	Willits	Mendocino	26	
	Mission Terrace Apartments	Boyes Hot Sprng	Sonoma	36	
	Bell Manor 1	Windsor	Sonoma	49	
	Kelebe-Tractenberg Company	Rohnert Park	Sonoma		15
	Copeland Creek	Rohnert Park	Sonoma		115
TOTALS				(405)	(130)
DISTRICT 2					
HERGER (R)	Paradise Gardens Apartments	Paradise	Butte	48	
	Highland Apartments	Oroville	Butte	88	
	Oroville Apartments	Oroville	Butte	62	
	Alexander Apartments	Arbuckle	Colusa	50	
	Colusa Gardens Apartments	Colusa	Colusa	96	
	Shasta Gardens Apartments	Orland	Glenn	49	
	Willow Oaks Apartments	Wilows	Glenn	60	
	Willow Apartments	Willows	Glenn	36	
	Burney Villa Apartments	Burney	Shasta	40	
	River Gardens Apartments, Phase I	Anderson	Shasta	48	
	River Gardens Apartments, Phase II	Anderson	Shasta	60	
	Manzanita Hills, Phase I	Anderson	Shasta	80	
	Manzanita Hills, Phase II	Anderson	Shasta	80	
	Senior Citizens Home of Yreka	Yreka	Siskyou	11	
	Juniper Terrace Apartments	Yreka	Siskyou	55	

Prepared by:
California Coalition for
Rural Housing Project

April 1987

FMHA SECTION 515 RURAL RENTAL HOUSING PROJECTS
SUBJECT TO EARLY PREPAYMENT
BY CONGRESSIONAL DISTRICT

LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 2					
(con'd)	Donner Trail Manor	Wheatland	Sutter	44	
	Centennial Arms Apartments	Live Oak	Sutter	21	
	Butte View Estates	Live Oak	Sutter	32	
	Corning Apartments	Corning	Tehama	44	
	Jackson Manor Apartments	Red Bluff	Tehama	44	
	Red Bluff Apartments	Red Bluff	Tehama	72	
	Red Bluff Meadows Apartments	Red Bluff	Tehama	52	
	Alberta Gardens Apartments	Linda	Yuba	48	
	Olive Tree Senior Citizens Apartments	Olivehurst	Yuba	44	
	Casa del Este Apartments	Linda	Yuba	56	
TOTALS				(1320)	
DISTRICT 3					
MATSUI (D)	Whispering Oaks	Elk Grove	Sacramento		33
	Elk Grove Apartments	Elk Grove	Sacramento		50
TOTALS					(83)
DISTRICT 4					
FAZIO (D)	Ty Del Apartments, Phase I	Dixon	Solano	28	
	Ty Del Apartments, Phase II	Dixon	Solano	28	
TOTALS				(56)	

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 6					
BOXER (D)	Village Green 1*	Sonoma	Sonoma	41	
	Green, Joseph A.	Cotati	Sonoma		20
TOTALS				(41)	(20)
DISTRICT 14					
SHUMWAY (R)	Courtyard Apartments	Plymouth	Amador	10	
	Ridgecrest Apartments	Placerville	El Dorado		46
	Citrus Manor Apartments	Susanville	Lassen	54	
	Meadowbrook Apartments	Susanville	Lassen	58	
	Mill View Apartments	Susanville	Lassen	52	
	Modoc West Apartments	Alturas	Modoc	12	
	Valley Commons	Grass Valley	Nevada	48	
	Valley Commons East	Grass Valley	Nevada	56	
	Springhill Gardens Apartments 1	Grass Valley	Nevada	72	
	Brookside I	Auburn	Placer	24	
	Brookside II	Auburn	Placer	24	
	Canyon View Senior Citizens Apartments	Colfax	Placer	67	
	Lynroc Senior Citizens Community	Rocklin	Placer	67	
	Lincoln Senior Citizens Community	Lincoln	Placer	70	
	Golden Village Apartments	Lincoln	Placer	49	
	Sunset Apartments I	Rocklin	Placer		28
	Sunset Apartments II	Rocklin	Placer		28
	Sunset Apartments III*	Rocklin	Placer	48	
	Valle Vista Apartments	Lincoln	Placer	44	
	Portola Senior Citizen Community	Portola	Plumas	50	
	Bethany Home Society	Ripon	San Joaquin	56	
	Willo Heights Apartments	Escalon	San Joaquin		33
	Sierra Valley Senior Citizens Community	Loyalton	Sierra	50	
TOTALS				(911)	(135)

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 15					
COELHO (D)	Mariposa Oaks Apartments	Mariposa	Mariposa	24	
	Los Banos Apartments	Los Banos	Merced	68	
	MacArthur Apartments	Los Banos	Merced	50	
	MacArthur Apartments #2	Los Banos	Merced	50	
	Gustine Garden Apartments	Gustine	Merced	34	
	Alicante Gardens	Livingston	Merced		30
	El Solyo Apartments	Patterson	Stanislaus	46	
	Garden Apartments	Oakdale	Stanislaus	42	
	Oakdale Apartments	Oakdale	Stanislaus	42	
	Selma Elderly Apartments	Selma	Fresno	24	
	Reedley Edlerly Apartments	Reedley	Fresno	23	
	Fowler Apartments	Fowler	Fresno	44	
	Garden Valley Homes	San Joaquin	Fresno	100	
	Garden Valley Homes #2	San Joaquin	Fresno	48	
	Mendota Gardens	Mendota	Fresno	60	
	Kerman Garden Apartments	Kerman	Fresno	93	
	Parlier Plaza	Parlier	Fresno	40	
TOTALS				(788)	(30)
DISTRICT 16					
PANETTA (D)	San Jerardo Apartments	Salinas	Monterey	60	
	Hill, Leslie E.	Greenfield	Monterey		5
	McLaughlin, Thomas #6	Morro Bay	San Luis Obispo	12	
	McLaughlin, Thomas #7	Morro Bay	San Luis Obispo	14	
	Stark, Robert A.	Baywood Park	San Luis Obispo		15
	Winston, Donald	Boulder Creek	Santa Cruz		10
TOTALS				(86)	(30)

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 17					
PASHAYAN (R)	Sunset Apartments	Wasco	Kern	24	
	Poso Manor Apartments	Wasco	Kern	64	
	Cork Elm #1	Wasco	Kern		12
	Cork Elm #2	Wasco	Kern		16
	Cork Elm #3	Wasco	Kern		8
	Lemoore Elderly Apartments	Lemoore	Kings	23	
	Amberwood Apartments	Hanford South	Kings	48	
	Whitley Gardens	Corcoran	Kings	64	
	View Road Apartments	Hanford	Kings	121	
	Villa San Joaquin	Lemoore	Kings	36	
	Exeter Elderly Apartments	Exeter	Tulare	24	
	Farmersville Apartments	Farmersville	Tulare	12	
	Dinuba Apartments	Dinuba	Tulare	76	
	El Monte West	Dinuba	Tulare	40	
	Village Grove Apartments	Farmersville	Tulare	48	
	Woodlake Apartments	Woodlake	Tulare	48	
	Alder Apartments	Porterville	Tulare	64	
	Bardsley Gardens	Tulare	Tulare	49	
	Evergreen Apartments	Porterville	Tulare	41	
	Lindsay Apartments	Lindsay	Tulare	60	
	Porterville Garden Apartments	Porterville	Tulare	63	
	Tulare Garden Apartments	Tulare	Tulare	64	
TOTALS				(969)	(36)
DISTRICT 18					
LEHMAN (D)	San Andreas Apartments	San Andreas	Calaveras	48	
	Madera Apartments	Madera	Madera	68	
	Valley Oaks Apartments	Madera	Madera	24	
	Sonora Garden Apartments	Sonora	Tuolumne	34	

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 18 (con'd)	Jamestown Apartments	Jamestown	Tuolumne		40
	Sonora Apartments	Sonora	Tuolumne	48	
TOTALS				(222)	(40)
DISTRICT 20					
THOMAS (R)	Mojave Villa Apartments	Mojave	Kern	52	
	Hallmark Apartments	Lamont	Kern	48	
	Walnut Apartments	Arvin	Kern	32	
	Skyway Apartments	Shafter	Kern	24	
	Tulare Arms	Shafter	Kern	48	
	Tropicana Village	Shafter	Kern		48
	Creston Gardens	Paso Robles	San Luis Obispo	60	
	Rolling Hills Apartments	Templeton	San Luis Obispo	53	
	McLaughlin, Thomas A. #1	Atascadero	San Luis Obispo		4
	McLaughlin, Thomas A. #2	Atascadero	San Luis Obispo		4
	McLaughlin, Thomas A. #3	Atascadero	San Luis Obispo		4
	McLaughlin, Thomas A. #4	Arroyo Grande	San Luis Obispo		17
	McLaughlin, Thomas A. #5	Atascadero	San Luis Obispo		17
	McLaughlin, Thomas A. #8	Arroyo Grande	San Luis Obispo		18
	McLaughlin, Thomas A. #10	Atascadero	San Luis Obispo		17
TOTALS				(317)	(129)
DISTRICT 21					
GALLEGLY (R)	Moorpark Villa	Moorpark	Ventura	47	
TOTALS				(47)	

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 35					
LEWIS (R)	Desert Manor Apartments, Phase I	Hesperia	San Bernardino		56
	Desert Manor Apartments, Phase II	Hesperia	San Bernardino		56
	Hesperia Garden Apartments	Hesperia	San Bernardino	112	
	Yucca Valley Oasis #1	Yucca Valley	San Bernardino		10
	Yucca Valley Oaks	Yucca Valley	San Bernardino	13	
	Park Adelanto Apartments	Adelanto	San Bernardino	30	
	Apple Valley Housing	Apple Valley	San Bernardino	12	
	Riverview Terrace Apartments	Needles	San Bernardino	60	
	Park Apple Valley Apartments	Apple Valley	San Bernardino	22	
	Searles Apartments	Trona	San Bernardino	60	
TOTALS				(396)	(122)
DISTRICT 37					
McCANDLESS (R)	Lakeshore Apartments	Lake Elsinore	Riverside	8	
	Lake View Apartments	Lake Elsinore	Riverside	88	
	Elsinore Shores	Lake Elsinore	Riverside		70
	Blythe Villa Apartments	Blythe	Riverside	52	
	Broadway Manor Apartments	Blythe	Riverside	64	
	Sabana Aire de Cortez Apartments	Temecula	Riverside		48
	Sabana Aire de Cortez # 2	Temecula	Riverside		48
	Casa del Sol Housing	Desert Hot Sprng	Riverside	60	
	Casa del Sol Housing #2	Desert Hot Sprng	Riverside	48	
	Coachella Valley Apartments	Coachella	Riverside	50	
	Coachella Valley Apartments #2	Coachella	Riverside	52	
	Desert Hot Springs Apartments	Desert Hot Sprng	Riverside	12	
	Mountain View Apartments, Phase I	Cathedral City	Riverside	84	
	San Jacinto Garden Apartments	Perris	Riverside	64	
	San Jacinto Vista Apartments #1	Perris	Riverside	48	
	San Jacinto Vista Apartments #2	Perris	Riverside	60	

Senator **Cranston**. Thank you very much.

CERTAIN REGIONS AFFECTED DISPROPORTIONATELY

It appears that certain regions of the Country are being affected disproportionately compared to others and I presume that the prepayment problem is particularly acute in the tightest housing markets, those with the least affordable housing for low and moderate income people.

I'd like to ask each or any of you a couple of questions.

What regions are likely to be hit most severely in the Country as you see it? Are some regions immune or in time are all regions going to be hit?

Mr. **Siflinger**. Mr. Chairman, when we look at the HUD study we see that the HUD study has indicated that there are certain regions that are or will be primarily affected now on the basis of current information. I mentioned those regions, California, Massachusetts, the Northeast in general, generally those areas of economic strength at the present time.

We believe, however, it's unfair to look at those regions and not take into account that these HUD mortgages were committed for 40 years and from the 21st year to the 40th year we believe it's fair to say that there is a continuing Federal obligation at least during that period to assist the low- and moderate-income tenants. And between that 21st and 40th year, as we know something about the history of this Country, we see that these present areas of economic distress more often than not regain their strength and they become the tight housing markets.

So I don't believe that there are any areas that are immune. Further, I would say that when these programs were initiated in the 1960's—and I certainly was at HUD at that time and I recently had an opportunity to speak to Dr. Weaver, who was the HUD Secretary during the 1960's and until 1968 and he made a very clear statement that it indeed was the intent of that administration and the Congress to assure that there would be a continuing Federal production presence and really that continuing Federal production presence would counter the effect of the lock-in expiration. And that was a basic assumption that was made.

Ms. **Peck**. Mr. Chairman, I'd like to agree with Mr. Siflinger. I don't think there are any areas that are immune to the potential for displacement.

We saw in California, a community like Rocklin, where maybe 10 or 12 years ago it was a fairly sleepy community. Hewlett-Packard moved in and developed a big plant and now what we're seeing is new workers coming into the community and vying for apartment buildings that previously low income people lived in.

In other communities around the country where there hasn't been displacement as a result of prepayment, there is nothing to guarantee that several years down the road those communities might increase in their economic strength and the rents are going to go up. There is no guarantee to protect those tenants from future displacement.

Mr. **Apgar**. If I might add something, conversions are going to be high in areas of strong market and growing rents. I feel that this tightening up of the rental market I noted is very widespread. I noted that there were particularly strong rent increases in the West led by California and in the Northeast with Boston and New York and Philadelphia being prominent examples. But throughout all the regions there clearly are metropolitan areas of very sharply increasing rents and a lot of pressure on the low income stock. Examples include in the Midwest, Minneapolis-St. Paul, and in the South, Atlanta. These are some of the other cities we have specific data on.

So it may be true that not every city is as tight as the national average, but there certainly are metropolitan areas in every region that are experiencing this rental housing crunch.

Senator CRANSTON. How much breathing room do you think Congress has in trying to come up with a solution? Do we have to act pretty swiftly?

Ms. PECK. Mr. Chairman, particularly for the section 515 program, the moratorium expires June 30, 1987. There is a provision in the supplemental appropriations bill to extend that through the end of September, which is valuable, but it doesn't give us much time.

We've got prepayments pending all over the country. We've got close to 200,000 units that could prepay at any time. We simply have to come up with the solution now. We have no time left.

Mr. SIFLINGER. It appears, Mr. Chairman, that the situation will get more serious with regard to the HUD inventory over time. There are relatively few units that are eligible for prepayment as of this date, but certainly over the next few months and within the next year that trend begins to show a rather alarming escalation. So although with regard to the HUD units there is some time, I think we're talking about months only, not even a year.

Senator CRANSTON. Secretary Demery testified about the need for Federal, State and private partnerships in solving the problems. Can I assume that all of you feel there has to be a quite assertive Federal role in this if we're going to get anywhere?

Mr. SIFLINGER. Absolutely.

Senator CRANSTON. I'll assume that's your feeling.

Mr. Apgar, Dr. Phillip Clay of MIT recently estimated that by the year 2003 more than 18 million Americans will be displaced or burdened with excessive rents or forced to live in slum conditions. How does your research compare with his assessments?

Mr. APGAR. I'm pleased to say that Phil Clay over the years has worked with us at the Joint Center and we are quite in agreement on growing trends of rental affordability and inadequate housing.

You asked the question earlier whether or not the current situation is likely to deteriorate in the near term and how fast we have to act.

Please note that my data are largely through the early part of the recovery of 1983 and 1984. These data don't reflect for example, what I believe to be the most severe impact of tax reform in terms of the cutback of new construction of rental housing, nor do the data fully reflect what I consider to be this continued surge of reinvestment and upgrading of the rental housing inventory.

So my numbers I think are conservative at best and are consistent with Phil Clay's sense that the housing affordability and the mismatch between rents and income on the renters' side is only going to grow in the future.

PROPOSED LEGISLATION TO AID DISPLACED TENANTS

Senator CRANSTON. Ms. Peck, one final question. The California Department of Housing and Community Development estimates that as many as 90 percent of low income tenants were ultimately displaced when Farmers Home loans were prepaid. Farmers Home claims that its recently proposed regulations will solve the problem of displaced tenants.

Could you comment on those regulations?

Ms. PECK. The regulations are a step in the right direction because they do provide for a longer term notice to tenants that there will be a prepayment and the potential for displacement.

They also allow tenants to take rental assistance with them to a new project and, of course, they give priority in going to another Farmers Home project—they extend that priority from 30 days to 60 days. I think they are just a step in the right direction. They are not going to stop displacement. They are not going to stop prepayments and there's no guarantee that people are going to find other housing because there's a very small vacancy rate in most rural communities.

We found waiting lists of 1 to 2 years in other subsidized projects and I don't see where there's alternative resources.

Unfortunately, one provision in H.R. 4 would allow for the prepayment of pre-1979 loans if in fact there's affordable rental housing available within 25 miles of the current project. First of all, I doubt that there's affordable and available housing, but just to allow for prepayment and allow for the displacement of people and the disruption of their lives simply because there may be housing 20 or 25 miles away doesn't make sense to me. We're talking about old people. We're talking about very poor people who don't have the money to relocate, to pay the first and last month's rent, to pay security deposits, to relocate their children in schools, to find new doctors for health problems. This is a disruption that just doesn't make sense.

Senator CRANSTON. Thank you very much and I thank all of you for your very helpful testimony. It's a pleasure to have you with us.

Our next witness now from the administration will be Vance Clark, Administrator of the Farmers Home Administration.

Mr. Clark, I welcome you. If you can, summarize your statement in 5 minutes, I'll appreciate it and your complete statement will appear in the record.

STATEMENT OF VANCE CLARK, ADMINISTRATOR, FARMERS HOME ADMINISTRATION

Mr. CLARK. I'll talk fast, Senator.

Good morning. I do appreciate this opportunity to be with you today to discuss a matter of considerable concern, the prepayment of section 515 rural rental housing loans and potential displacement of low income tenants.

This problem came about because of a variety of economic factors, largely related to population and economic growth, and primarily affects projects built with FmHA section 515 rural rental housing loans made prior to December 21, 1979. Borrowers who received their loans before that date and have not subsequently become subject to restrictive use provisions due to servicing actions, can pay off the loan after 60 days notice to FmHA.

In practice, this means that low income tenants are entitled only to notification that they are eligible for letters awarding them priority at other FmHA-financed projects, and 30 days notice before rents are raised, and nothing more. Occupancy at other projects depends upon vacancies being available, of course.

Various factors, including the extension of loan eligibility to limited profit entities and tax incentives then existing, made it profitable, in some areas, to prepay the loan after a few years and then sell or convert the property to general occupancy with no low income tenants.

For loans made after December 21, 1979, legislative changes effective in December 1979 imposed restrictions on use and removal of the property from the low income market for 15 years without prior FmHA approval if there is no interest credit, rental assistance or section 8 funding involved. The restrictions extend for 20 years where there is such assistance.

DISPLACEMENT OF TENANTS IS A PROBLEM

Although the displacement of tenants is a problem, it is not a general one. Of 15,452 FmHA rural rental projects in operation as of today, 8,000 were funded before December 21, 1979. That figure represents 52 percent of the projects with 44 percent of existing rental units. The older projects tend to have fewer units.

The problem is more acute in areas with large population growth and where property values are rising faster than in most other areas, for instance, parts of California and Washington on the west coast and in the New York/New England area in the east.

In most parts of the country, in rural areas such as Iowa, prepayments have caused little or no problems for tenants because economic factors would not support higher rents. In fact, in many areas, such as the oil-producing States, vacancies leading to delinquency are the major problem.

Mr. Chairman, in your invitation to me to appear today, you asked for my views on what effect H.R. 4 would have in solving the problem before us.

Briefly put, the H.R. 4 provisions dealing with prepayment would be extremely expensive and far too sweeping in scope to deal with a problem of a limited nature, and adds another year before we can accept prepayment even if retaining restrictive use. We estimate it would cost more than $3.2 billion to assist 5,000 units a year for 5 years when counting all anticipated subsidies for the life of the loan. More specifically, the cost would be $440 million over the next 5 years to assist 25,000 units.

The "life-of-the-loan" estimate, however, includes $307 million for equity grants, $1.5 billion for the 46 percent of tenants not currently receiving deep tenant subsidy, and $1.4 billion to replenish deep subsidy for the tenants currently receiving it when the original commitments expire.

The President's 1988 budget proposes to provide 21,000 rental housing vouchers to replace all of the rural housing programs and has set aside vouchers for low income tenants displaced or threatened with higher rent resulting from prepayments. If Congress were inclined to appropriate funds for section 8 certificates, in lieu of vouchers for these displacements, the administration would support this.

Currently, there are 1,200 vouchers set aside for displacements, rising to 2,400 in 1992, in addition to the 20,000 vouchers proposed for rural areas in the 1988 FmHA budget. The total cost for the 21,200 vouchers would be $378 million. If vouchers were made available only to displaced tenants who could not find other FmHA housing, the cost would be far less.

SUGGESTED REGULATIONS

Rather than requiring new legislation, which would be prohibitively expensive, we feel that the displacement problem can be resolved administratively. The language in P.L. 99-500 imposing the moratorium on prepayments until June 30 gave us time to develop regulations. We feel we should allow some time to see how these regulations work before making substantial legislative changes.

The regulations we are considering would require:

One, transferring rental assistance from prepaying projects to those FmHA projects able to absorb displaced tenants and giving displaced tenants priority to continue receiving rental assistance.

Two, borrowers to notify the FmHA 6 months in advance of their intent to prepay instead of the 2-month period currently required. FmHA would notify tenants 6 months in advance of the pending request.

Three, allowing tenants facing displacement to apply for letters authorizing priority placement at FmHA projects before the loan at the project where they are living is prepaid.

Four, and, this is most important, annual, instead of monthly, leases in all rental housing projects. Any rent increases proposed due to prepayment would be prohibited until after the expiration of any existing lease term.

These changes will solve the problem of displaced tenants efficiently, promptly and at reasonable cost. Because of this, and because the president's budget calls for the voucher program to replace the rural housing programs generally, we are strongly opposed to section 306 of H.R. 4.

This completes my statement, Mr. Chairman. I will be happy to attempt to answer any questions you might have.

[The complete prepared statement of Vance L. Clark follows:]

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California Coalition for
Rural Housing Project

April 1987

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LEGISLATOR	PROJECT NAME	LOCALITY	COUNTY	TOTAL UNITS AT RISK	TOTAL UNITS PREPAID
DISTRICT 37 (con'd)	Cherrywood Senior Apartments	Beaumont	Riverside	39	
	Beaumont Park Apartments	Beaumont	Riverside		33
	Vista de San Jacinto #1	San Jacinto	Riverside		52
	Vista de San Jacinto #2	San Jacinto	Riverside		52
	Vista de San Jacinto #3	San Jacinto	Riverside		52
TOTALS				(720)	(305)
DISTRICT 43					
PACKARD (R)	El Mancor de Cortez	San Marcos	San Diego		80
	Summerwood Properties	Fallbrook	San Diego		32
	La Galiana de Cortez	Fallbrook	San Diego		48
TOTALS					(160)
DISTRICT 45					
HUNTER (R)	Labrada, Robert C.	El Centro	Imperial		26
	McCabe, Chester V.	Imperial	Imperial	4	
	Lugo, Jorge B.	Imperial	Imperial	3	
	The Spring Apartments	Brawley	Imperial	64	
	Town and Country Apartments	Holtville	Imperial	42	
	Imperial Villa Apartments	Imperial	Imperial	40	
	Peppertree Apartments	Ramona	San Diego	32	
TOTALS				(185)	(26)
TOTALS FOR ALL DISTRICTS				6373	1246

* Prepayment approval pending

STATEMENT OF
VANCE L. CLARK, ADMINISTRATOR
FARMERS HOME ADMINISTRATION
UNITED STATES DEPARTMENT OF AGRICULTURE
Before the
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
June 5, 1987

Good morning, Mr. Chairman and Members of the Committee. I appreciate the opportunity to be with you today to discuss a matter of considerable concern -- the prepayment of certain 515 rural rental housing loans and potential displacement of low-income tenants.

This problem came about because of a variety of economic factors, largely related to population and economic growth, and primarily affects projects built with FmHA Section 515 rural rental housing loans made before December 21, 1979. Borrowers who received their loans before that date, and have not subsequently become subject to restrictive use provisions due to servicing actions, can pay off the loan after 60 days notice to FmHA.

In practice, this means that low-income tenants are entitled only to notification that they are eligible for letters awarding them priority at other FmHA-financed projects, and 30 days notice before rents were raised, and nothing more. Occupancy at other projects depends upon vacancies being available, of course.

Various factors, including the extension of loan eligibility to limited profit entities and tax incentives then existing, made it profitable, in some areas, to prepay the loan after a few years and then sell or convert the property to general occupancy with no low-income tenants.

For loans made after December 21, 1979, legislative changes effective in December, 1979, imposed restrictions on use and removal of the property from the low-income market for 15 years without prior FmHA approval if there is no interest credit, rental assistance or Section 8 funding involved. The restrictions extend for 20 years where there is such assistance.

Although the displacement of tenants is a problem, it is not a general one. Of 15,452 FmHA rural rental projects in operation as of today, 8,000 were funded before December 21, 1979. That figure represents 52 percent of the projects with 44 percent of existing rental units. (The older projects tend to have fewer units.)

The problem is more acute in areas with large population growth and where property values are rising faster than in most other areas, for instance, parts of California and Washington on the West Coast and in the New York/New England area in the East.

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Mr. Chairman, in your invitation to me to appear today, you asked for my views on what effect H.R. 4 would have in solving the problem before us.

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The "life-of-the-loan" estimate, however, includes $307 million for equity grants, $1.5 billion for the 46 percent of tenants not currently receiving deep tenant subsidy and $1.4 billion to replenish deep subsidy for the tenants currently receiving it when the original commitments expire.

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The regulations we are considering would require:

1. Transferring rental assistance from prepaying projects to those FmHA projects able to absorb displaced tenants and giving displaced tenants priority to continue receiving rental assistance.

2. Borrowers to notify the FmHA six months in advance of their intent to prepay instead of the two-month period currently required. FmHA would notify tenants six months in advance of the pending request.

3. Allowing tenants facing displacement to apply for letters authorizing priority placement at FmHA projects before the loan at the project where they are living is prepaid.

4. And, this is most important, annual, instead of monthly, leases in all rental housing projects. Any rent increases proposed due to prepayment would be prohibited until after the expiration of any existing lease term.

These changes will solve the problem of displaced tenants efficently, promptly and at reasonable cost. Because of this, and because the President's Budget calls for the voucher program to replace the rural housing programs generally, we are strongly opposed to Section 306 of H.R. 4.

This completes my statement, Mr. Chairman. I will be glad to answer any questions you might have.

Senator CRANSTON. Thank you very much.

You state that your proposed regulations "will solve the problem of displaced tenants efficiently, promptly and at reasonable cost."

You then state that your regulations "would require transferring rental assistance for prepaying projects to those Farmers Home projects able to absorb displaced tenants and give displaced tenants priority to continue receiving rental assistance."

I want to ask you a series of questions about those proposed regulations.

What studies have you done to assure that there are sufficient undersubscribed Farmers Home projects to absorb displaced tenants?

Mr. CLARK. Well, again, Mr. Chairman, it's a pocket situation. Those problems are more acute on the west coast and the east. Generally, we feel that that is a true statement. Certainly there will be problems in those populated areas.

Senator CRANSTON. You don't think the problem is elsewhere?

Mr. CLARK. Generally, no.

Senator CRANSTON. What studies have you made to verify that?

Mr. CLARK. We do have statistics on all the prepayments issues that have arisen. Again, those real problems are in concentrated areas, Iowa, a very rural State for example, has had 28 projects prepaid in the last 3 years and they are very small projects, a total of 28 projects with only about 148 units. So it's not a general problem nationwide.

Senator CRANSTON. Given these projects are in rural areas and given that prepayments occur in tight rental markets, what's the likelihood that there will be vacancies for these tenants anywhere near, reasonably close to their present home?

Mr. CLARK. It's probably not a very good opportunity for the other units. That's where the voucher program comes in.

Senator CRANSTON. How far would a typical low income tenant have to move to live in another Farmers Home project, 25 miles, 50 miles, 100, what?

Mr. CLARK. I'm not sure I can answer that question, but as I travel the Nation, again, our problem is so different than HUD's in the metropolitan areas. Those small communities, sometimes they are 5 or 10 miles apart. Some are 20. I really can't answer that question. However, if the voucher program was provided, those tenants could use vouchers to remain in those units and not move.

Senator CRANSTON. Many of the tenants in section 515 projects are quite elderly. What studies have you done to assess whether the burden you have proposed is reasonable for quite elderly people?

Mr. CLARK. It's true we do serve a broad spectrum of elderly housing and I'm not sure I can give you numbers on specifics of our total projects, but I get the feeling nationwide that that's not our prime goal out there in rural America. About a third of our projects are designated for the elderly, and so 44 percent of our tenants are elderly. Another 4 percent of our tenants are handicapped.

Senator CRANSTON. I'm not sure what the situation is in all other parts of the country, but it appears to me that the waiting lists in a State like California is so long that the notion of transferring rental assistance is really a fictional myth. I don't know how it's going to work there. What sort of a solution do you have for places like California where there is such a tight situation?

Mr. CLARK. We're also going with new units in those areas where we think that possibility does exist. California is unique and different and thank goodness we've got companies like Hewlett Packard coming in so that community can go on and prosper.

Our tenants are outside those metropolitan areas. Rocklin, of course, is a bedroom community of the Sacramento area up in the foothills, but we think there is an opportunity there for new units to be constructed.

Senator CRANSTON. Well, I hope you're correct. Thank you very much. I presume there may be some written questions from other members of the committee.

Mr. CLARK. Thank you, Senator.

Senator CRANSTON. Now we go to our third panel which will present us with solutions and some recommendations. Because of the number of witnesses on this panel, I particularly ask that you stick to the 5-minute rule. Our first witness will be J. Roderick Heller, president and chief executive officer of the National Corporation for Housing Partnerships here in Washington; followed by Marilyn Melkonian, president of the Telesis Corp., Washington, DC; then Barry Zigas, president of the National Low Income Housing Coalition; then Daniel Grady, chairman of the Preservation Task Force, National Advisory Council of HUD Management Agents; and finally Deane Earl Ross, president of the Associated Financial Corp. from Pacific Palisades, CA.

Mr. Heller, I appreciate your presence.

STATEMENT OF J. RODERICK HELLER, III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

Mr. HELLER. Thank you, Senator.

I am pleased to be here this morning. The National Housing Partnership, as you may be aware, is a creature of Congress established in 1970 pursuant to the 1968 Housing Act to stimulate the flow of private capital to low and moderate income housing. NHP today in fact is the largest owner of low- and moderate-income housing in the country with 60,000 units. We have a total of 80,000 units in our portfolio.

We have never allowed a project to go into foreclosure and have invested over $50 million over the years to keep our projects economically viable.

We are here today concerned about the existing stock of low and moderate income housing. We are concerned because, as previous witnesses have testified, we have major problems over the next 20 years. Our concern relates not only to prepayment, however, but continuation of subsidies.

I would like to address today not only the specific program aspects which many of the other witnesses will address but some broader policy questions related to changes in the housing industry that I think this committee should note.

There are four interrelated factors that I believe do affect the committee's judgment.

EFFECT OF TAX REFORM ON DEVELOPERS

First is perhaps most importantly the effect of tax reform on developers, particularly the general partners of low and moderate income housing. Much has been said about the loss of the individual investor. Equally, we have a concern that many investors now of low- and moderate-income housing will not continue to contribute as investors the funds required for the upkeep of the project.

There's yet another factor, though, that is very important. That is the number of general partners of low- and moderate-income housing partnerships that are no longer economically viable. It's not generally known but the second and fourth largest owners of low- and moderate-income housing in this country are in bankruptcy and you could imagine the adverse effect on the projects of this development.

A second factor relates to the fiduciary obligation of general partners. NHP is a schizophrenic organization in many respects. We were created to develop and maintain low- and moderate-income housing. At the same time, we have investors as limited partners who are looking to us to exercise our fiduciary obligation.

It is not clear—and I speak as one who practiced law for 20 years—precisely what is the general partners' obligation. I don't mean to suggest that in every circumstance the general partner has to go to the highest and best use for his property, but it is a difficult issue and I do think it's fair to say that most general partners are going to have to confront exactly that problem if there is any possibility of conversion.

A third factor is the trend toward consolidation in the apartment industry. I think the apartment world is much like the hospital world was 25 years ago. It was then dominated by local ownership and to some degree nonprofit operation. Apartment ownership today is highly fragmented. Although we have only 80,000 units, we are the second largest owner of apartments generally in the country out of 27 million rental units. But consolidation is beginning.

Major firms are beginning to invest in apartments and that is going to affect the flow of capital into low income housing which traditionally has not afforded the kind of returns that major institutions will find.

The fourth factor relates specifically to institutionalization. Because of the tax act, and because of the adverse effects on investors, there is an increasing concentration on investment in apartments from major pension funds and other institutional sources. Wall Street and the pension funds are largely determining the flow of capital into the apartment market. That factor, too, has to be noted by the committee as it addresses this broad issue.

USE OF PENSION FUNDS

We, for example, are working now with major State pension funds in terms of trying to channel funds not only to low- and moderate-income housing but to apartment ownership generally.

We see a convergence of a lot of these factors. At the very time when prepayment opportunities arise, there is a lesser availability of capital from the traditional sources and new reliance on institutional investors which have fiduciary obligations to obtain the highest returns. We are fearful that the convergence of these factors will make it very difficult to attract the additional capital that we believe is necessary not only to develop new low- and moderate-income housing but also to maintain that which we have.

We have presented in House testimony a number of specific proposals of ways of dealing with this. We think there are many different categories of issues and we believe there needs to be a menu of solutions. But the National Housing Partnership, which was a creature of Congress, has decided that one approach would be for us to get far more data on the problem and try to present it to this committee and the House committee before enactment of legislation.

I am impressed, as a relative newcomer to this field, how much passion is engendered by the whole issue of prepayment and how little of a factual base exists. We don't know how many units will be prepaid. Personally, I think interest rates will have more effect on prepayment than anything that this committee will do.

What NHP accordingly has done, and will be funding, is the creation of a blue ribbon panel chaired by Carla Hills and Henry Reuss, bipartisan in character. It includes representatives such as economists Martin Feldstein and Charles Shultz, Mayor Diane Feinstein, ex-Governor Bill Millikin, and representatives of the housing industry such as Larry Simon and David Maxwell. We believe this panel will be able to bring to this committee informed judgment and, more importantly, significant data insights. We're going to be spending the next 7 months collecting data in some detail on representative projects and I hope that we will be in a position to help this committee deal with this issue.

[The complete prepared statements of J. Roderick Heller, III follow:]

TESTIMONY BY THE

NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

ON THE

PRESERVATION AND PROTECTION OF THE

LOW AND MODERATE INCOME MULTIFAMILY HOUSING INVENTORY

PRESENTED BY

J. RODERICK HELLER, III

PRESIDENT AND CHIEF EXECUTIVE OFFICER

TO THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

JUNE 5, 1987

I am pleased to appear before the Committee on behalf of the National Corporation for Housing Partnerships. NCHP is unique, a private entity created by Congress in 1968 with the purpose of encouraging the development of low and moderate income housing.

Today, NCHP

- owns more low and moderate income multifamily rental housing than any other private entity,
- is the largest manager of low and moderate income rental housing, directly managing almost 60,000 units, and
- has never returned a single mortgage to HUD - an accomplishment requiring not only dedication and hard work, but almost $50 million in loans to projects.

We are privately owned (with Berkshire Hathaway and Weyerhaeuser being our principal shareholders) and operate on a national scale, with over 500 rental properties located in 39 states, the District of Columbia and Puerto Rico.

As most of you are aware, there are approximately 27 million rental units in the United States today. Much of this, however, consists of single-family houses rented to others. The multi-family component itself is highly fragmented. (As an example, NHP is the largest owner and operator of low and moderate income housing - and the second largest owner of apartments generally - but with only 80,000 units.) The largest owner and operator of apartment units has approximately 90,000 units.

The critical element for low and moderate income families - and national housing policy generally - is the stock which is owned or subsidized by the government. Although there are surprising discrepancies in various reports as to the number of subsidized units, we have accepted the GAO/HUD determination that there are approximately 1.8 million units of privately owned but federally assisted housing stock.

There has been increasing media attention to the possible loss of much of this stock, and your committee will undoubtedly receive conflicting proposals and advice on this issue. Much of the discussion will focus on particular programs and markets, with the attention to detail which is the hallmark of sound policy. Although NCHP will give you its own proposals and views on specific programs and the like, I would like to examine the issue today in a broader context.

In my view there are four broad yet interrelated reasons why some of this housing stock is in danger of being lost as low and moderate income housing. These reasons are (1) the fiduciary obligations of the general partner in housing partnerships, (2) tax reform, (3) the increasing institutionalization of apartment investment and (4) the coming national consolidation in apartment ownership.

1. Fiduciary Obligation. Almost all privately owned but federally assisted low and moderate income housing projects are owned by partnerships controlled by one or more general partners. As many of you know - and the point is certainly clear to those of you who are lawyers - a general partner is a fiduciary, and held to the highest standard of accountability and trust to his limited partners. Generally speaking, the general partner must seek the highest attainable financial return for his investors. The precise definition of a general partner's fiduciary obligation shifts in response to the particular facts and circumstances. In the case of low income housing many investors may have anticipated tax benefits only, assuming, when they invested, that the long-term use of the property would remain low-income housing. Other investors may have carefully selected their low-income housing investments

with the expectation that by the time use restrictions expired the property would be convertible to market rate use. At NHP, almost all our low-income housing projects are owned by NHP and limited partner investors, and reconciliation of our fiduciary obligation and interest in the use of this housing for low and moderate income families represents a major issue and dilemma for us.

This problem is exacerbated by the policies undergirding the whole federal housing program. For instance, although often forgotten, the premise of the initial program was that much of the orginally subsidized private stock would be converted to market rate use after 20 years; with newly built housing replacing the converted stock. In addition, an ancillary outcome of this country's justifiable insistence that government assisted housing have a decent standard of construction and amenities has been to reduce, if not eliminate, the difference between assisted and market rate housing, thus enhancing the assisted housing's conversion potential. Similarly, maturing social policy required that low and moderate income housing be dispersed, and much housing is to be found in attractive suburbs. Finally, some of the subsidized housing was built in urban fringe areas in the hope and expectation that the construction would help upgrade the areas. Upgrading in fact often has occurred and the formerly fringe areas are now highly desirable locations.

These are some of the policy and legal pressures to convert current low-income housing stock to market rate housing. It is our hope that alternatives to full market rate conversion of properties will be fashioned for use by general partners who must determine which property disposition proposals to make to investors.

2. Tax Reform. There are few of us here today who are not fully sated with tax reform, and yet equally few who are certain of the consequences of this far-reaching legislation. One thing, I believe, however, is clear - that low and moderate income housing is a clear loser. There are only three points I want to stress in this over-discussed area.

First, the tax bill certainly will reduce individual investment in low-income housing. Tax benefits have been almost the only reason to invest in this housing, since low income projects do not typically generate distributable cash flow, and cannot be viewed as likely to appreciate (even though some have). Moreover, Congress has retroactively eliminated bargained-for tax benefits, and few investors will want to risk being treated so unfairly again. The low income tax credit is useful in some ways, but has serious deficiencies as a vehicle for significant volume activity, particularly in new construction.

Second, tax reform will accelerate the loss of the supply of federally subsidized housing. Just as there is federally assisted housing that will be converted to market rate, so there is federally assisted housing that will never have residual value, and only the prospect of continued tax losses justify continued ownership and maintenance for current and future investors. We estimate that somewhat more than one-quarter of federally subsidized housing can be used only for low and moderate income families, largely due to location. With the loss of tax benefits over the next several years, there will be little economic incentive for owners to maintain this category of low income housing stock. There is a high probability that many of these owners will simply walk away, and add more units to those already deteriorating.

Third, reform has hastened the demise of many general partners. Many developers and/or syndicators depended on a continuous flow of fee income from sales to cover overhead, and many general partners, particularly smaller ones, will be unable to survive. Thus, part of the country's housing production mechanism will disappear.

3. Institutionalization - Tax reform will only accelerate a process already under way - the growing institutionalization of apartment investment. With the incentive for investment by individuals greatly reduced, apartment developers will increasingly turn to pension funds and Wall Street for equity - as well as debt - capital. These institutions are not primarily drawn by tax benefits (which to some degree are still available for business, if not individuals), but to the total potential return on their investment. Indeed, pension funds are also fiduciaries and have no other option. Needless to say, low-income housing - without any form of subsidy - cannot possibly compete with market rate projects for available institutional dollars.

4. Consolidation. As I earlier noted, apartment ownership is highly fragmented and inefficient. The industry is not unlike the hospital industry 25 or more years ago. Just as the hospital industry changed, so will ours. Ownership of apartments will be concentrated in fewer hands, and the industry will increasingly be dominated by a few large concerns which can bring computerization, volume purchasing and access to large pools of capital.

    This trend, too, has ominous implications for low income housing. These large institutions are not eleemosynary and, unless there is an economic reason to so do, they will neither develop nor maintain low and moderate income housing.

If I am correct in my assessment of these trends, and if they converge as I anticipate, there will be an increasing loss of low and moderate income units beginning in the next several years. At just the time the pool of existing units is threatened by the expiration of use restrictions and subsidy contracts, tax reform is eliminating the principal incentives used to induce continued equity ownership in low and moderate income housing. Moreover, the capital which is available for investment in apartments is increasingly institutional and will support the trend to consolidation of apartment ownership by national investment managers and developers. These conditions often exclude low income housing projects from consideration on economic grounds alone.

Against this backdrop, what can be done?

First, the above discussion suggests that the bases upon which private capital supported low and moderate income housing programs have changed. Even if we wished to return to the Great Society approaches, we could not do so. Circumstances require that a new approach be forged for ensuring an adequate supply of low and moderate income housing. Any such approach will necessarily involve a greater role for state and local governments, for private foundations, for non-profit groups and for concerned citizens. The private sector must continue to play a significant role but it is even of more importance that the federal government continue to be a major source of funding and basic program structure. There is simply no way to build and operate low-income housing without subsidies - and from a realistic and practical viewpoint only the national government can provide the long term funds of guarantees required.

Second, the change that has occurred means that Congress should not move too precipitously to try to fashion a new approach. As a relative newcomer to housing, I have been impressed by how much rhetoric and passion surrounds the subject of low-income housing.

I do not believe we really yet know all the hard facts on which to base our decisions in this arena. In our haste to rectify a present problem let us not create bad housing policy.

The lack of factual data is particularly marked when the question of the federally subsidized but privately owned stock is discussed. We simply do not know how many units probably will be converted, or how many units will be allowed to deteriorate if expiring subsidies are not renewed and provisions are not made for physical improvements. Factors that few can predict, such as the level of interest rates over the next five years, will certainly affect the answer to the question as well.

NHP feels the responsibility under its Congressional charter to help provide leadership to stem the severity of the loss of our low and moderate income housing stock. To that end, NHP is sponsoring the organization and operation of the National Low Income Housing Preservation Commission. This committee, which has been established with support of the House Housing Subcommittee (and, we hope, this Subcommittee) will be chaired by former HUD Secretary Carla Hills and former House Banking Committee Chairman Henry Reuss. It will be comprised of a bipartisan group of distinguished Americans, and will be supported by a technical advisory group knowledgeable about low income housing data. I am attaching a list of Commission members. This committee, although established and funded by NCHP, is independent of NCHP and will report its findings and conclusions to Congress.

The Commission's work will be focused on three areas:

1) development of a detailed data base from which meaningful conclusions can be drawn regarding the possible loss of the housing stock;

2) possible intervention strategies; and

3) possible funding sources.

The Commission, with the aid of the technical advisory staff, expects to develop information on finance, tenant profile, composition, rental comparables and other relevant factors for a large and representative number of HUD assisted projects. We hope that the Commission's work will prove especially valuable to this Subcommittee as it begins to deal with the issue.

Third, there have been suggested a number of possible solutions to the specific issues involved with respect to preservation of the existing stock. We have testified before the House Housing Subcommittee on this issue, and, rather than repeat or summarize our views, I am attaching our earlier testimony as a statement of our position.

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Senator CRANSTON. We hope that that approach will coincide with our efforts on the next major bill that we're going to be working on.

Mr. HELLER. I hope so.

Senator CRANSTON. Thank you very much.

Ms. Melkonian.

STATEMENT OF MARILYN MELKONIAN, PRESIDENT, TELESIS CORP. WASHINGTON, DC

Ms. MELKONIAN. Thank you, Mr. Chairman. I want to thank you for inviting me to comment on the important subject of these hearings.

I'm very pleased to be before this committee of which I have strong memories. First, in 1967 when I had a vantage point behind the chairman as a legislative aide to Senator Brooke. Later, regularly in front of the committee as a Deputy Assistant Secretary of HUD in the Carter administration, and now as a private citizen interested in the same issues.

I am the president of Telesis Corp., a private company working to maintain and expand the supply of affordable housing with community development corporations, tenant organizations, private owners and local governments.

I will briefly summarize the principal ideas presented in my written statement.

As has been and will be pointed out by other witnesses, with elaboration and detail, and as the committee knows, we are currently losing more affordable housing than we are providing. Because of an administrative decision made in the early stages of implementing the housing production programs of the 1960's to permit owners to withdraw from these programs after 20 years, and because of the termination of subsidies both voluntary because of owner withdrawal and involuntary because of funding expiration, the likelihood, unless changed, is that the cost of hundreds of thousands of housing units will rise out of the reach of their current occupants, families whose incomes are representative of over 30 percent of all Americans. Lower income Americans who do not live in assisted housing are already either not finding or are paying exhorbitant amounts of their income for housing.

With that understanding, the appropriate civilized response would be, as it was 20 years ago, to find ways to increase the supply of affordable housing. But, although we are in the same room as we were 20 years ago, we do not have the same values or priorities.

CRITICAL JUNCTURE IN NATIONAL HOUSING POLICY

We have arrived at a critical juncture in national housing policy. Federal funding of production of low income housing has been virtually halted. We have been governed for the last 6 years by twin fallacies that the private economy unleashed solves all ills, including lack of housing; and, that the Government bears no responsibility toward a growing segment of our society for such basic needs as housing. As a result, we now face some decisions about what is the proper role of Government, private enterprise and the individual in meeting those needs.

We face this issue in dealing with the question of the owner's right to prepay an assisted mortgage and convert the project to another use on the 20th anniversary date of the mortgage. Because of this right, a large part of the existing low income housing stock developed by the private sector may be lost in the pursuit of profit maximization.

This stock was developed under the section 221(d)(3) and 236 programs, the first major Federal commitments to encourage the participation of private enterprise in the provision of housing for low and moderate income families. To accomplish this the Government provided mortgage insurance, which meant high leverage and low risk; below-market rate loans to lower rents and finance developer and builder fees, and substantial tax benefits to attract investors who provided equity and profits. Builders, developers, syndicators, and investors were attracted to the programs, not because they believed in long-term appreciation as the source of return for their capital and labor, but because they were compensated through the program structure and through the tax code. Tenants benefited from lower rents.

Now that highly productive and successful arrangement is in danger of becoming unravelled because of an administrative, not legislative, decision to permit owners to terminate low income use after 20 years.

I believe that Government, private owners of the housing and housing consumers must reaffirm the original social compact, not only to preserve the housing built by the private sector through Government programs, but also to set the stage for a new commitment of resources for the production and preservation of affordable housing by the private sector.

PREPAYMENT DILEMMA

With the prepayment dilemma upon us, some have argued that involving the private sector in the development and ownership of housing was a mistake that should not be repeated in the event of a new commitment of Federal resources for housing. The industry's handling of the prepayment issue should be viewed as a litmus test and referendum on future private sector participation in the provision of low- and moderate-income housing. I believe that the vast majority of owners are open to solutions to the prepayment problem which will protect the long-term interests of tenants. It is the Government's role to see to it that workable solutions are developed.

The task of arriving at a solution acceptable to a majority of owners is made easier simply because ownership of assisted housing is heavily concentrated in the hands of well under 1,000 owners. I think the owners of more than half the assisted housing stock may be represented at this table.

There are a variety of tools which can be used to enable owners to maintain low income use. These include extension of section 8 loan management subsidies, a critical need; the Capital Improvements Loan Program proposed in H.R. 4; greater use of the Flexible Subsidy Program; modification to the new low income tax credit program; other tax code revisions such as forgiveness of tax due on a sale when a project is sold to an entity that agrees to maintain low income use. These and other possibilities should be explored and many suggestions will be forthcoming from the very able groups studying the problem.

This approach is necessary. But it must be undertaken with a deep commitment to preserving this irreplaceable housing stock for low income use for the full mortgage term.

Many private sector representatives insist that any change in the period of restricted use would be an unconstitutional taking or impairment of the contract. They also regard any limitation on the profits to be gained from sale or refinancing as heresy. There are Supreme Court precedents which indicate otherwise as discussed at length in the statement I am submitting for the record.

I believe that both research into this issue and understanding of the interests at stake will convince the Congress to mandate low and moderate income use for the full mortgage term notwithstanding contractual provisions to the contrary. At the very least, this question should receive the most serious and open consideration.

H.R. 4—"OWNERS' BILL OF RIGHTS"

H.R. 4 in its present form would preclude that opportunity. H.R. 4 contains what can only be called an "Owners' Bill of Rights" while providing no meaningful protections to tenants.

Section 261(a) of H.R. 4 entitled "Prepayment of Mortgages" directs the Secretary to develop and implement policies and programs to ensure the continued availability of the assisted stock as affordable housing while at the same time.

> Respecting the rights of owners, including (but not limited to) existing contract rights to prepay mortgages and convert units to other purposes, to receive a fair and equitable return on their investment, and to be able to fully meet outstanding mortgage and other financial obligations secured by or related to the ownership, management, or operation of projects as such obligations become due, and to receive fair market value on any sale or transfer of their property.

This language is not merely hortatory. At this point in the debate, it is the equivalent of handing down the verdict before the case is heard. If enacted, it would tie Congress' hands in enacting future legislation in this area. This language assumes the answer to questions that have not been thoughtfully considered or researched. What were owner and investor expectations of economic benefit in participating in these HUD programs? What financial rewards have been conferred on owners and investors, including those not contemplated by the original legislation, such as an additional cycle of tax benefits under the Economic Recovery Tax Act of 1981? What is the proper balance between the owner's expectation, if any, of receiving the benefit of appreciated value of an assisted housing project and the public interest in preservation of this resource as affordable housing?

Only when those questions are answered can we proceed to find fair solutions which will uphold the rights of families to decent, affordable housing and in the end benefit us all.

I would be happy to answer any questions the committee may have.

[The complete prepared statement of Marilyn Melkonian follows:]

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As of June 1, 1987

TESTIMONY BY THE

NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS

ON THE

PRESERVATION AND PROTECTION OF THE

LOW AND MODERATE INCOME MULTIFAMILY HOUSING INVENTORY

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COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

OF THE

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NATIONAL CORPORATION FOR HOUSING PARTNERSHIPS TESTIMONY BEFORE SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT ON THE PRESERVATION AND PROTECTION OF LOW AND MODERATE INCOME HOUSING

The National Corporation for Housing Partnerships is a diversified, full-service real estate company primarily engaged in the development, management and ownership of multifamily rental housing. It was chartered by Congress in 1968 to stimulate the production of low and moderate income housing, and now owns almost 60,000 such units in over 400 properties, more than any other entity in the United States. NCHP is also one of the largest property managers of multifamily housing, with over 56,000 units under management, and also owns almost 10,000 units of market rate housing.

Almost 90% of NHP's portfolio consists of projects containing low and moderate income rental units. Approximately half of that portion of the portfolio consists of older subsidized projects insured under Sections 236 and 221(d)(3) of the National Housing Act. Through partnerships it manages, NCHP is the owner of approximately 34,000 such older subsidized units. Thus, NCHP has a deep concern with the future of this housing.

The issues facing this Subcommittee today stem from the original design of the subsidized multifamily housing programs. The programs were founded upon three basic principles:

- o Mortgage interest rate subsidies and direct rent subsidies would bring the housing costs within the reach of low and moderate income residents;
- o Tax shelter benefits would attract passive investment capital through limited partnerships which would generate the equity necessary to attract long term financing; and
- o Use restrictions would ensure the low and moderate income character of the housing for at least twenty years. Definite expiration dates would attract capital from private investors and would encourage lending institutions to provide reasonable interest rates.

Chief among these principles were the tax benefits designed to provide the equivalent of an economic return on the investment. Since the assisted developments were designed to provide only a very limited cash return on investment, the tax benefits were substituted as the chief inducement for investment.

These founding principles also anticipated a continuation of government-assisted housing; and thus assumed that, as the use restrictions and subsidies expired, other similarly assisted housing units would take their place. Thus owners, such as NCHP, would fulfill their fiduciary obligations to their investors by, where feasible, refinancing and converting these units to market rate use with no negative consequences to the nation's low and moderate income housing supply, since any units so converted would be replaced by other new units.

however, these principles have not been fulfilled. Budgetary constraints and tax reform have virtually eliminated interest and income subsidies and the opportunity to pass tax benefits through to a new generation of investors. Thus, as NCHP and other similar fiduciaries fulfill their legal obligations to their current investors, the unfortunate and unintended consequence is to reduce the supply of low and moderate income housing.

The dilemma thus facing this Subcommittee and other housing policy makers is how to preserve this housing while simultaneously operating within budgetary and tax reform restraints and while observing the legal obligations owners such as NCHP have to their investors. In other words, the task before us is to fashion legislation restructuring the original profit motivated programs to provide sufficient incentives to current and future investors to outweigh the attractiveness of refinancing and conversion -- at a cost affordable to the tax-payers.

Let me divide these issues into their four basic components and suggest policy initiatives for each one:

- Expiring Use Restrictions

  Approximately 5,000 properties are included in the older subsidized inventory. These properties typically have about 25 years yet to run on their mortgage subsidies and low and moderate income use restrictions. About 40 percent of them are not eligible to prepay their mortgages and come out from under the use restrictions without the FHA Commissioner's approval since they have received Flexible Subsidy or Rent Supplement assistance or have been developed by nonprofit sponsors. The remaining 60 percent are eligible to prepay their subsidized mortgages without the FHA Commissioner's approval when 20 years have elapsed since the final endorsement of FHA insurance on their mortgages. Although some of these latter properties have already reached the end of their 20-year lock-in period, most will not be so eligible for about another five years. Some of these prepayment-eligible properties are in such desirable locations that their conversion to market rate use is inevitable and the public costs of stemming such conversions would be prohibitive. Other such developments will never be conversion candidates due to their undesirable locations. Further detailed analysis is required, but I would suggest that perhaps 20 percent of these developments are in the "inevitable" category and approximately 35 percent in the "never" category. That leaves about one-half of the prepayment-eligible inventory in a position where the investors and their fiduciaries, like NCHP, will be making economic decisions to balance the benefits of conversion against the continuing provision of low and moderate income housing.

  I would suggest that the members of this Subcommittee and other housing policy makers concentrate their resources on this "tippable" portion of the inventory, since that is where the greatest public benefit can be obtained with the least expenditure of government capital. I would further suggest that increasing the return on and recovery of equity by modest and gradual rent increases in exchange for use restriction extensions would provide the economic inducements sufficient to preserve some low and moderate income housing units beyond their current conversion points.

  It is quite feasible to gradually raise the rents to say 30 percent of 80 percent of median income (which is well within the low and moderate income limits), with appropriate protections for very low income residents, thus creating additional income to support higher equity returns and withdrawals in exchange for reasonable use restriction extensions. The Department of Housing and Urban Development has already authorized such an approach for some properties insured under the §221(d)(3) BMIR Program using existing statutory authority. I reccommend that this authority be expanded to the §236 Program.

  Second, included in the Housing Legislation currently under consideration is a right of first refusal on the sale of projects whose owners plan to prepay the mortgage covering the assisted project by a governmental or non-profit entity that agrees to maintain the low and moderate income character of such projects. Given the significant impediment to sale created by this provision, we have great doubts as to its legal effectiveness and enforceability. At a minimum, however, I urge this Subcommittee in considering this proposal to carefully define fair market value, to provide a mechanism by which a property owner can challenge such a value, and to set a specific deadline for exercising such a right.

  I would caution this Subcommittee to recognize that neither of these approaches will be panaceas or will be executed at no cost. The inducements require increased rents and possibly greater subsidy costs; and the purchases will require public funds.

- Expiring and Terminating Income Subsidy Contracts

  The recently completed GAO study on this subject vividly documents the number of income-subsidized units which will expire or are eligible for termination in the near future. As is the case with use-restricted properties, some of these contracts are in developments located in such desirable markets that the owners have no economic option but to terminate the subsidy when they are legally entitled to do so.

  Perhaps half of these contracts are tied to projects in the "tippable" category where the owners are very likely to let them run their full length. But at least one-third of these contracts are tied to developments that must always operate as subsidized projects. I would therefore suggest that the major problem is not terminations of subsidy contracts by owners but expirations of such contracts in developments that are unable to attract market rate tenants. These expirations will precipitate significant cash flow deficits and could lead to mortgage defaults and insurance claims.

  The cost to the government of such claims and the inevitable foreclosures that would ensue would be at least equal to if not greater than the cost of continuing the subsidy contracts. It is therefore essential that strategies be developed now to prevent these consequences by continuing the subsidy contracts or providing some equivalent support.

  Whatever is done, it is essential that the subsidies remain attached to the units in properties that will remain low and moderate income. To permit the assisted tenants to "walk" to other housing, as they could do under the voucher program, is a wasteful policy since the subsidy costs would still be incurred without dealing with the core problem of preventing operating deficits, defaults, claims, and foreclosures. In fact, in soft market situations, the provision of "walk away" vouchers would accelerate such problems. Portable vouchers could be used, however, to assist lower income tenants through the transition to market rate use for those developments that fit in the conversion category -- as long as the project-based subsidy is not removed prematurely.

  Moreover, as is the case with use restriction extensions, it is reasonable for the residents to pay somewhat more for their housing so that such housing may continue to be assisted in the face of today's budgetary constraints -- as long as the assistance level is high enough to prevent operating deficits.

  Due to budgetary constraints, not all of the amendements increasing the original contract authority were allocated sufficient budget authority to carry them through the full remaining term of the contract. It is thus important that all contracts currently in place be fully funded to cover any current amendments for the full remaining term of the contract. Longer range provisions also need to be made for any additional amendment needs.

- Deteriorating Physical Condition

The properties under consideration today are facing significant physical restoration needs. While estimates by such sources as the National Association of Home Builders and the Department of Housing and Urban Development vary, there is no doubt that the needs exceed the available resources. A sample study of NCHPs older subsidized inventory indicates a per unit per annum need of $500 - $600 for replacement and repair of critical components and systems, with annual escrow deposits running only one-third of that amount. Even if all the current and projected reserves are completely depleted, the gap over just the next five years is in excess of $1,000 per unit -- and such needs will continue at a similar level in subsequent years.

If these needs are not met, the resultant deterioration will increase the motivation to convert to market rate use where possible or to abandon the developments where that is the only recourse. Rents can and should be increased somewhat to meet this need; but market and subsidy constraints place tight limits on such an approach.

Let me therefore suggest two additional strategies:

- The Flexible Subsidy Program's eligible uses should be expanded to include capital improvements with the simultaneous establishment of a revolving fund approach that encourages the repayment and recycling of outstanding loans; and
- The loan program, proposed in the legislation now before this Subcommittee, should be enacted to provide secondary financing for capital improvements.

Such programs should be structured to encourage reasonable low and moderate income use restriction extensions in exchange for the capital improvement assistance. I would suggest therefore that the use restriction extension in Subtitle C should be shortened to the greater of ten years or the repayment of the loan.

- Tax Reform Impact

While laudable in its overall objectives, the impact of tax reform on these older subsidized developments will encourage both conversions and abandonments for two reasons. First, the recently enacted tax legislation has a retroactive impact on currently owned projects. Even though the bill protects some more recent investors' abilities to deduct passive losses, it fails to protect fully investors in older syndications, deems certain project interest earnings to be "portfolio" income (which must be reported as unsheltered income to investors) and fails to provide a useful mechanism to permit the sale of such projects to new owners. Since tax benefits under the prior law provided the only "economic" return from low income housing and since that return has been reduced, the most likely result will be disinvestment in such property or insistence that the use of such property be changed as rapidly as possible to allow for a real economic return, thus replacing the lost tax benefits.

Second, the new low income housing tax credit will not replace the lost tax benefits for existing projects. Since any projects last syndicated fewer than 10 years ago do not automatically qualify, many of the projects most at risk of default are not, without special waiver, eligible for the credit. Older properties placed in service more than 10 years ago similarly are in jeopardy since the credits must be allocated by state agencies under procedures mainly left to be devised, competing for allocations with new construction and substantial rehabilitation credits. Significant extensions in the low income use restrictions are required -- beyond the income subsidy contract expiration dates. The qualifying rent levels will place a squeeze on cash flow from unassisted units. Moreover, it is unlikely that the credits will be attractive to investors because they cannot exceed $7,000 per year over ten years, can be used to the full extent only if, in any given year, the investor does not earn over $200,000 and are not available at all to investors whose annual income exceeds $250,000. Experience since enactment of this program has borne out these criticisms and shown that the program only works where substantial other forms of local, state, and federal assistance are provided.

I would therefore urge this Subcommittee to consider, at the earliest possible opportunity, modifications of the tax provisions for existing low and moderate income housing investments and appropriate restructuring of the tax credit. Such modifications could take the form of restarting tax benefits for owners who extend their lock-ins, forgiving capital gains upon sale to an entity that will preserve the properties' low and moderate income character, and increasing the credit's benefit to investors. Given the critical importance of tax provisions to the preservation issue, I would also urge this Subcommittee to play a very active role in the development of Tax Legislation.

In order to preserve and protect the low and moderate income housing inventory it will be necessary to reactivate the original profit equivalency principles built into these programs at their inception by:

- Increasing the return on equity,
- Continuing the current project-based income subsidy programs,
- Helping to repair and refurbish the deteriorating developments, and
- Modifying the tax reform provisions.

By "giving some" of the above incentives it will be possible to "get some" badly needed preservation and protection of the low and moderate income multifamily housing portfolio in private sector hands.

In conclusion let me stress three principal points:

- It is at least of equal, if not greater, importance that the issues of physical deterioration and subsidy expirations be dealt with along with prepayments. Many more low and moderate housing units will be lost to those two causes than to conversions.
- Since inducements and restrictions can only deal with a small portion of the potential prepayments, only changes in the tax legislation sufficient to attract new investors will deal with the problem in any significant manner.

- Although some immediate legislative actions should occur, many of the problems and proposals relating to this issue will require thorough and objective analysis before they can be considered for legislative action. Thus, while urging quick action on the incentives, flexible subsidy modifications, preservation loans, and subsidy contract extension recommendations stated above I would also urge the Subcommittee to accept NCHP's offer to, under the mandate of its congressional charter, convene a task force to develop specific policy recommendations on the broader issues for this Subcommittee's use in the 1988 legislative cycle.

The National Corporation for Housing Partnerships is honored to be able to present testimony on preserving the low and moderate income inventory and looks forward to working with this Subcommittee and its staff on protecting this vital housing resource.

Senator CRANSTON. Thank you very much.
Mr. ZIGAS.

STATEMENT OF BARRY ZIGAS, PRESIDENT, NATIONAL LOW INCOME HOUSING COALITION

Mr. ZIGAS. Thank you, Mr. Chairman.

I join the other witnesses in thanking you for the opportunity to testify today and also congratulate you on holding this hearing on such an important issue.

My name is Barry Zigas and I am president of the National Low Income Housing Coalition, a national nonprofit, nonpartisan organization that works in Washington to foster better and more effective programs to provide low income housing for low income people.

When I was invited to testify, I was asked to speak about recommendations we would make for action for the Senate to take, so I would like to focus my remarks today on that. I have a longer written statement that I would like to submit for the record at this time.

Mr. ZIGAS. A couple of things have come forward in this hearing.

INADEQUATE ANSWERS FOR PROBLEMS

The first of these is, we have heard many questions and many different points of view about how severe the problem is in the short-term and long-term. We come today to urge you to acknowledge the fact that there is an inadequate supply of information about the extended homelessness that may result from it and inadequate answers for providing a solution to its problems.

Because of that, I am here today to urge you and the Senate to adopt a time-limit moratorium on any prepayment of HUD-assisted housing until such solutions can be reached through a consensus process.

A moratorium is not designed as a long-term solution. It is not designed as a substitute for a long-term solution. It is designed to provide time to create long-term solutions that are fair and equitable and designed to provide a time to protect tenants who might otherwise be displaced, while solutions are being generated. It will create, frankly, a level playing field for all owners and all tenants and remove any possible incentives that owners might find in the next few months to hasten their decision to prepay to escape possible Government regulation that is pending in Congress.

A second area I want to urge you to focus on is to protect the rights of the tenants. I cannot agree more with the statements of Senator D'Amato earlier today, as he described the need to protect tenants' rights and to ensure if, in the future under any circumstances, a project is prepaid and the use is converted that the tenants are guaranteed relocations to affordable housing of comparable size and amenities.

We do not believe that vouchers and certificates are a substantial or adequate answer to this problem. Vouchers and certificates will not replace the affordable stock. They will simply add to the number of people seeking it in a market which has fewer units available, once low income properties subsidized by the Government are converted out of low income use. They offer assistance to cope with what is available but provide no actual affordable units in contrast to the project-based subsidies this Congress enacted many years ago.

I would also ask Congress to pay particular attention to assertions that this might be a cost-effective means of protecting tenants and assuring their continued occupancy in affordable housing. It is very difficult for me to believe that with these projects—paid down and operating under very low interest mortgages—that it will somehow be cheaper for the Government to operate in the unregulated high interest rate private market environment and offer to pay a large amount of money to subsidize their rents and that could possibly be more economic or cheaper for the Government than finding a solution to maintain the occupancy of the existing stock.

Another area I urge you to consider is to create a right of first refusal for tenants in these properties, if they are, indeed, prepaid and offered for sale. We believe it is critical to create a mechanism which can be used to facilitate the passage of these units out of the speculative private ownership market into a nonspeculative market where their low income occupancy and use will be preserved, accompanied by adequate funding to preserve affordable rents.

TRUST FUNDS

For that purpose, we urge you to establish preservation trust funds similar in some regards to a fund that has been established in the House legislation, H.R. 4. This fund can be financed with recaptures of budget authority from expiring contracts or terminated contracts. For instance, this should include repayments of subsidized loans, as well as other revenue sources. And I would urge you also to consider funding such a trust fund with a windfall profits tax on properties being sold for a substantial profit after having been subsidized by the Government for 20 years.

We believe the Federal Government has a fiduciary interest, as well, for the taxpayers, to assure that it reaps some long-term benefit from the enormous investments they have made in these properties.

In the long range, there are three areas I urge you to turn your attention to and act on quickly.

One is on maintaining housing subsidies and the remaining stock of housing. On this, I know the National Housing Partnership could not agree more. There is a vast supply of this housing which is not in danger of being sold. It is in danger of being allowed to deteriorate. We must step in and offer solutions to owners and tenants to facilitate their rehab and continue their use.

Another area is that of expiring subsidy contracts. Nobody could more eloquently describe the dilemma we face than these charts you have today. I would simply suggest that this is a much, much greater area for important work than some of the others we have discussed today.

My testimony has suggestions for long-term solutions.

Finally, I would suggest that the lessons of this whole crisis that we are facing and the potential prepayment and disposition of assisted housing should teach a valuable lesson. I believe that as Congress looks to new legislation as your work in the next year progresses, it is important for us to take a lesson from this and say that the nonspeculative ownership of housing should be a major principle of new programs which we develop.

Entrepreneurs clearly have a role to play in development of low income housing. They have skill and are willing to undertake risks and have access to funds. Providing a reward for that skill does not necessarily require the granting of ownership interests which, in the long run, places the owner's interests and tenants in contrast.

I see my time is up. I will be happy to answer any questions.

[The complete prepared statement of Barry Zigas follows:]

STATEMENT OF MARILYN MELKONIAN

PRESIDENT, TELESIS CORPORATION

I am very pleased to be here this morning and to be included in this distinguished panel to comment on the important subject of preserving the existing stock of federally assisted housing.

I am the President of Telesis Corporation, a private company working to maintain and expand the supply of affordable housing with community development corporations, tenant organizations, private owners and local governments. My interest and involvement in housing issues began with this Committee in 1967 when I served as legislative assistant to Senator Brooke and was active in the formulation of the Housing Act of 1968 and subsequent legislation. In private law practice, I represented developers and syndicators of assisted housing, and later served as Deputy Assistant Secretary for Multifamily Housing in the Carter Administration with direct responsibility for preserving the housing stock developed under the Section 221(d)(3) and 236 programs, which is the subject of today's hearings.

A little over twenty five years ago, the federal government made the first major commitment to subsidized housing for low and moderate income people, housing which would be privately built and operated. It did so with the policy objective of encouraging the widest possible participation by private enterprise in the provision of housing for low and moderate income families. To accomplish this the government provided mortgage insurance, which meant high leverage and low risk; below-market rate loans to lower rents and finance developer/builder fees, and substantial tax benefits to attract investors who provided equity and profits. Builders, developers, syndicators, and investors were attracted to the programs, not because they believed in long term appreciation as the source of return for their capital and labor, but because they were compensated through the program structure and through the tax code.

Since John F. Kennedy signed the Housing Act of 1961 twenty six years ago this month, and opened the door to private sector involvement in providing low and moderate income housing, federal assistance has flowed to the private sector. It flowed more or less continuously until this Administration decided that private enterprise could meet the housing needs of all Americans without government subsidies, a thesis contradicted by all evidence, including the rising tide of homeless people.

We have arrived at a critical juncture in national housing policy. Federal funding of production of low income housing has been virtually halted. At the same time, because of an administrative decision, made in the early stages of the program, permitting owners to prepay assisted mortgages and convert projects to other uses on the twentieth anniversary date of the mortgage, a large part of the existing low income housing stock developed by the private sector may be lost in the pursuit of profit maximization.

I believe that government, private owners of the housing and housing consumers must reaffirm the original social compact, not only to preserve the housing built by the private sector through government programs, but also, to set the stage for a new commitment of resources for the production and preservation of housing by the private sector.

With the prepayment dilemma upon us, some have argued that involving the private sector in the development and ownership of housing was a mistake that should not be repeated in the event of a new commitment of federal resources for housing. The industry's handling of the prepayment issue should be viewed as a litmus test and referendum on future private sector participation in the provision of low and moderate income housing. I believe that the vast majority of owners are open to solutions to the prepayment problem which will protect the long term interests of tenants. It is the government's role to see to it that workable solutions are developed.

The task of arriving at a solution acceptable to a majority of owners is made easier simply because ownership of assisted housing is heavily concentrated. Indeed, it is safe to estimate that ownership of the 600,000 units that comprise the older assisted stock is concentrated in the hands of well under 1,000 owners.

If, on the other hand, I have misjudged the situation and owners are unwilling to accept solutions that will protect the long-term affordability of the stock, then I would recommend that Congress enact legislation requiring continued low and moderate income use of the property for the full mortgage term. Many private sector representatives insist that any change in the period of restricted use would be an unconstitutional taking or impairment of contract. They regard any limitation on the profits to be gained from a sale or refinancing as heretical. (I will respond to this constitutional point later in my testimony.) It should be noted at the outset that some of the very industry representatives who argued so vociferously, during the tax reform debate last year, that low income housing should be treated differently from other real estate because it does not produce cash flow or long term appreciation in value, and that tax benefits provide the only economic value for ownership of this housing, are now seeking to cash in on the appreciated value of the housing.

Mindful of the FmHA prepayment moratorium and concerned that Congress might alter the 20 year prepayment and conversion provisions, certain industry representatives have succeeded in persuading members of the House to include an "owners bill of rights" in H.R. 4. Section 261(a) entitled "Prepayment of Mortgages" directs the Secretary to develop and implement policies and programs to insure the continued availability of the assisted stock as affordable housing while at the same time:

> respect(ing) the rights of owners, including (but not limited to) existing contract rights to prepay mortgages and convert units to other purposes, to receive a fair and equitable return on their investment, to be able to fully meet outstanding mortgage and other financial obligations secured by or related to the ownership, management, or operation of projects as such obligations become due, and to receive fair market value on any saleor transfer of their property. (emphasis)

This language is not merely hortatory. This language assumes the answer to questions that have not been thoughtfully considered or researched. What were owner and investor expectations of economic benefit in participating in these HUD programs? What financial rewards have been conferred on owners and investors, including those not contemplated by the original legislation, such as an additional cycle of tax benefits under the Economic Recovery Tax Act of 1981? What is the proper balance between the owners expectation, if any, of receiving the benefit of the appreciated value of an assisted housing project and the public interest in preservation of this resource as affordable housing? If enacted, it would tie Congress' hands in enacting future legislation in this area.

Having followed the evolution of the House legislation, I find it rather remarkable that this bill started out as a serious effort to protect low and moderate income tenants from displacement by providing, for example, a right of first refusal to nonprofits and government agencies to purchase projects that would otherwise be prepaid and converted to non-low income use, instead it has devolved into a bill with some toothless tenant protections and a legislative mandate for owners to maximize profits. There certainly is no foundation for this owners bill of rights in the 221(d)(3) and 236 enabling legislation which was designed to give the "highest priority and emphasis...to meeting the housing needs of those families for whom the national goal (of a decent home and suitable living environment for every American) had not become a reality."

As Secretary Weaver stated in 1968 when arguing for enactment of the legislation which created the National Housing Partnership "the business community...would be attracted by the opportunity to earn a fair return while solving a national problem." I think the Former Secretary, and many others who participated in the creation of the Housing Act of 1968, would be appalled by the idea that this legislation sanctions maximizing profits to the business community while exacerbating a national problem. I do not believe it does.

I find it very interesting that in 1979 the Congressional Research Service was asked to prepare a legal memorandum on whether retroactive changes in the FmHA program, designed to preserve the affordable nature of assisted projects would be constitutional. CRS concluded that the proposed legislation was constitutional, and did not effect "taking" without just compensation. (A copy of the CRS memorandum is submitted for the record.) The FmHA legislation was adopted, only to be repealed a year later in its retrospective effect when the industry threatened litigation.

How have we come from a point of deciding that curative legislation is not only advisable but also constitutional to an attitude of accepting at face value industry claims that prepayment and conversion opportunities are sacrosanct, and that owners, not low income tenants, deserve protection? I believe that legislators and other concerned parties who refuse to consider any alteration of these agreements or proposals to recapture part of the profits realized from a conversion of this housing have adopted this position because they do not know the facts about owner expectations, the financial benefits that have been realized by owners thus far, or the economics of continued operation of this housing for the benefit of low and moderate income people. Informed debate has been largely supplanted by self-righteous exhortations about free enterprise and property rights.

At this point, I would like to discuss whether Congress could constitutionally mandate low and moderate income use for the full mortgage term, or in the alternative, impose a "windfall profits tax" on owners who prepay and convert the housing to market rate rental use or condominiums. In considering whether such legislation would violate the Fifth Amendment injunction against taking private property for public use without just compensation, the factors described by the Supreme Court in Pennsylvania Central Transportation Co. v. City of New York, 438 U.S. 104 (1978) are instructive. The owners of Grand Central Station challenged the New York City Landmarks Preservation Commission's refusal to permit the construction of a 50-story office building over the terminal which had been designated a landmark. In deciding whether these local law restrictions constituted a taking the court considered (1) the economic impact of the regulation on the owner and, in particular, the extent to which it interfered with distinct investment-backed expectations, (2) the character of the government action, and (3) whether the restriction was reasonably related to a substantial public purpose.

The Court concluded that the landmarks law had not effected a constitutionally impermissable taking because there was no interference with the original use of the facility, and no showing that this use was not "economically viable". Government action resulting in a diminution of property values does not constitute a taking. This continues to be the Court's view of the takings clause in cases involving exercise of state police powers as well as cases involving exercise of Congress' constitutional powers. See, Kirby Forest Industries v. United States, 467 U.S. 1 (1984); Agins v. Tiburon, 447 U.S. 255 (1980), Andrus v. Allard, 444 U.S. 49 (1979).

In cases challenging federal legislation altering the rights of parties who have contracted with the government, the Court has made clear that only in rare cases will a contract be construed to foreclose the subsequent exercise of sovereign authority. In the recent case of Bowen v. Public Agencies Opposed to Social Security Entrapment, 54 U.S.L.W. 4699 (U.S. June 19, 1986), the Court upheld an amendment to the Social Security Act which prevented states from withdrawing employees from the system even where a termination notice had been filed prior to the amendment's enactment. The State of California alleged that the statutory amendments were unconstitutional insofar as they nullified a voluntary withdrawal provision in the state's agreement with the federal government. Quoting prior precedent the Court emphasized that:

> [W]ithout regard to its source, sovereign power, even when unexercised, is an enduring presence that governs all contracts subject to the sovereign's jurisdiction, and will remain intact unless surrendered in unmistakable terms. Therefore, contractual arrangements, including those to which a sovereign itself is party 'remain subject to subsequent legislation' by the sovereign.

54 U.S.L.W. at 4707

Although the issue requires further research, there appears to be precedent for legislation that would prevent owners of 221(d)(3)(BMIR) and 236 housing from withdrawing from the programs prematurely, notwithstanding language in contracts entered into with HUD permitting unrestricted prepayment after twenty years. Such legislation would be based on the well-established principle that government may adjust the benefits and burdens of economic life to promote the common good. This is particularly true in heavily regulated areas. We have seen many contract adjustments in the pension planning area, Peick v. Pension Benefit Guaranty Corp., 724 F.2d 1247 (7th Cir. 1983) and in the Hill-Burton area, American Hospital Association v. Schweiker, 721 F.2d 170 (7th Cir. 1983) which have been sustained.

Precedent for a "windfall profits tax" on owners who prepay and convert low income housing to market rate housing can be found. Adams Nursing Home of Wilmington v. Mathews, 548 F.2d 1077 (1st Cir. 1977). This is one of a series of cases where the owners of nursing homes that had received substantial financing through the medicare program challenged regulations issued by the Secretary of HEW relating to depreciation of capital investments, because the prior rules allowed for a substantial and unforseen windfall to these owners. The Secretary restricted future use of accelerated depreciation prospectively but also issued regulations recapturing accelerated depreciation benefits from providers leaving the program. These rules, challenged on due process grounds, were upheld.

There is ample precedent in the low income housing area for legislation adjusting an owner's contractual rights and Thorpe v. Housing Authority of Durham, 393 U.S. 268 (1969); FHA v. The Darlington Inc., 358 U.S. 84 (1958), South East Chicago Comm'n v. HUD, 488 F.2d 1119 (7th Cir. 1973), City of New York v. Rapgal Associates, 649 F. Supp. 1505 (S.D.N.Y. 1986).

It is curious that HUD officials seem to have accepted without question the premise that owners have an unalterable right to prepay and convert projects to market rate housing after 20 years. Yet, in other contexts, we see the Department's lawyers arguing the opposite position. The Multifamily Mortgage Foreclosure Act as amended in 1983 gave HUD the discretion to impose low income use restrictions on private foreclosure sale bidders. 12 U.S.C. Sec. 3703 (1984). Because these restrictions tend to depress the bid prices, and thus reduce or eliminate equity return, the owner claimed that this was an unconstitutional taking without just compensation. The Department successfully argued in federal court that these restrictions are lawful because they are necessary to effectuate the purpose of the 221(d)(3)(BMIR) and 236 programs and claimed that "restrictions which merely devalue property or diminish the project's profitability do not effect a taking within the purview of the Fifth Amendment." United States of America v. Stage I Land Company, No. 3-84-1097, No. 3-85-421 (D. Minn. 1985) (Plaintiffs Memorandum In Support Of Its Motion for Summary Judgment and For Dismissal of Counterclaims). Citing the Pennsylvania Central and Agins decisions discussed above, HUD argued that the relevant test of low income use restrictions is whether they deny an owner an "economically viable use" of his property. This should be the starting point for our analysis of prepayment legislation.

Is continued ownership of the housing as low income housing economically viable and if not, what can be done to make it so? Certainly continued provision of Section 8 Loan Management subsidies would be an appropriate quid pro quo for a mandatory extension of low income use restrictions. With all of the concern about prepayments and cancellation of Section 8 contracts we must not lose sight of the fact that contracts are expiring by their own terms. Most Section 8 Loan Management contracts will begin to expire in 1991. In that year, 95,000 units will lose rental assistance unless the program is continued or a replacement program is authorized. Contracts on 47% of the Section 8 Loan Management units will expire between 1991 and 1995, and the remaining 51% by the year 2000.

The Capital Improvements Loan program proposed in H.R. 4 is another good tool, as is the Flexible Subsidy program. The newly authorized low income housing tax credit, if modified to accomodate the peculiar aspects of the existing federally assisted housing stock, would be another means of assuring the economic viability of private sector ownership of the assisted stock. A revision of Section 1039 of the Internal Revenue Code to provide a forgiveness of tax due on a sale when a project is sold to an entity that agrees to maintain low income use, would be yet another way of preserving the assisted stock. Other tax code changes, such as relief from the passive loss restrictions and installment sale rules, would also be beneficial.

I regard this array of direct spending and tax subsidy proposals not as inducements but as the predicate for legislation that retrospectively alters agreements between owners and HUD, to mandate low and moderate income use for the full mortgage terms.

Almost 20 years ago, the Chairman of this Committee, Senator Sparkman, called for the passage of the Housing Act of 1968 and pointed out that "The housing needs of the American people...are not something that can be defined once and for all time, at any given period.... What appeared to be a satisfactory solution to yesterday's problem will be unacceptable today."

These are not easy issues to resolve. One does not lightly suggest that a prior agreement between the government and private individuals should be changed, but it is not unprecedented and can be justified as furthering a substantial public purpose. Before thoughtful legislative solutions can be fashioned, three questions must be answered: What did owners reasonably expect, what return have they received on their investments, and what is needed to maintain economically viable ownership of low income housing?

With those questions answered we can proceed to find fair solutions which will uphold the rights of families to decent, affordable housing and in the end benefit the commonweal.

National
Low Income Housing Coalition
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[illegible] Chairperson
Barry Zigas, President

PREPARED STATEMENT OF BARRY ZIGAS
PRESIDENT,
National Low Income Housing Coalition

ON

RECOMMENDED CONGRESSIONAL ACTIONS TO PREVENT DISPLACEMENT AND
HOMELESSNESS THROUGH LOSS OF FEDERALLY-INSURED, PRIVATELY OWNED
LOW INCOME HOUSING

BEFORE THE
SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

June 5, 1987

Mr. Chairman, distinguished members of the Subcommittee, my name is Barry Zigas. I am President of the National Low Income Housing Coalition, a national nonprofit, nonpartisan membership organization which provides advocacy services for improved and adequate federal assistance to end the low income housing crisis. I appreciate the opportunity to appear before you today to share our views on steps which Congress should take to address the prepayment of HUD-insured and subsidized mortgages on properties housing low and moderate income people.

I would like to cover several areas in my testimony. First, I would like to review the extent of the low income housing crisis which is gripping America today, to put the need for preserving these valuable housing resources in perspective. Second, I would like to outline immediate actions which my organization endorses and recommends to the Senate for its prompt consideration. Finally, I would like to outline a number of proposals which we believe the Congress should consider to provide long-range relief from the dilemma which we are now facing.

THE LOW INCOME HOUSING CRISIS

Low income people face an unprecedented housing crisis. A principal cause of homelessness is the severe lack of affordable housing for low income families.

The 1983 Annual Housing Survey conducted by the Census Bureau for HUD found that 5.4 million renter households earned less than $7,000, or a little more than 50 percent of the renter median income of $12,900. Over half of these households paid more than 60 percent of their income for rent.

Among renters with incomes below $3,000 per year, the shortage of affordable housing is even more acute. A total of 86 percent of these 2.2 million households paid more than 60 percent of their income for rent in 1983.

These are the very lowest income tenants in America. Yet they are paying the highest rent burdens of any income group, either among owners or renters. And since 1970, their plight has worsened.

America has experienced an unprecedented loss of affordable housing stock during the decade of the 1970's. In 1970, there were almost 15 million housing units affordable to a household earning $5,000 or less a year. By 1980 this number had dwindled to less than 3 million. The number of renter households with incomes of $5,000 or less also shrank during this period, but only to about 6 million, leaving half as many units as families.

In the last five years, this loss of affordable housing in the private sector has been coupled with a nearly 60 percent reduction in federal housing assistance funds. Moreover, almost the entire focus of federal housing assistance is now placed on subsidizing rents in existing housing, and limiting such assistance to rental units.

Based on information gathered by the General Accounting Office (GAO) and the

Senator CRANSTON. Thank you very much for your very helpful testimony.

Mr. Grady.

STATEMENT OF DANIEL B. GRADY, CHAIRMAN, PRESERVATION TASK FORCE, NATIONAL ADVISORY COUNCIL OF HUD MANAGEMENT AGENTS, SAN DIEGO, CA

Mr. GRADY. Thank you very much, Mr. Chairman.

I am chairman of the National Advisory Council of HUD Management Agents which is an independent body of 46 property management firms and associations who together manage the majority of all privately owned Government assisted housing in the country.

Some 3 years ago we established a committee to study the problem of preservation and in February of this year the Council established a task force consisting of knowledgeable members of the housing industry, representative of tenant organizations, including Mr. Zigas—Ms. Melkonian is also on our task force—and representative of its own members.

The task force held its first meeting in April, broke up in certain subcommittees which are currently at work, and which are discussing in depth some of the following subjects.

Owner incentives, expiring subsidy contracts, prepayment of existing mortgages, tenant impact, and State and local initiatives.

The final report of the task force is due in late October. We urge that the Congress await that report, together with the reports of other groups, before undertaking comprehensive legislation dealing with the preservation of assisted housing.

I would like to talk about a couple of projects that I have included in the testimony which I submitted in my report which I think outline some of the problems which many of these projects face today.

There's a project in Escadido, for instance, a 236 project, which was built in the early 1970's. At that time the cost was approximately $17,000 per unit. This project was sold recently under the HUD regulations at $23,000 per unit. The outstanding balance of the mortgage was now a little under $12,000 per unit. The difference between the sales price and the outstanding balance was paid by the new owners in cash.

The new owners at the time they bought it can only receive $92 per unit per year return on their investment, or a little less than 1 percent per year. It's interesting also that under their current regulations the basic rents which are charged in that project are limited to $235 per month. The so-called market rent is $288 per month. The project is primarily occupied by senior citizens which households of one or two persons. Some of these senior citizens, because of the limits on mission, are actually paying as little as 20 percent of their income even if they pay the market rents.

Under those conditions, there could be some inducement that could be provided to maintain that type of a project in the inventory, an inducement which would not overly burden the tenants.

Why did these original developers who had kept this project all the time sell? Primarily, Mr. Chairman, because the original developer was limited to that return of $92 per unit per year. The project had been depreciated and the original owner was now paying income taxes on phantom income which he did not receive many times in excess of that $92 which he was allowed to receive.

Why did the new owner buy? Because he was able to start a new depreciation schedule and he could buy a project at a substantial discount from the cost of similar apartments unfettered by Federal regulations and was hoping that in 1992 he could prepay the mortgage and increase his return to an acceptable level.

Currently there's been no effect on the tenants except for a small increase in rent because of the way the California taxes their property. We believe that adequate inducement, such as a modest increase in rent, modest increase in allowable return on equity, could be cost effective and could maintain this project in the stock.

However, besides there are a number of other problems and I want to be very brief and touch upon them. One of the biggest problems in the preservation of housing stock that affects many projects also in California is the fact that 5 year LMSA contracts are expiring. This has been touched upon by other witnesses. Certain of those projects were not originally built as housing assistance stock but rather as market projects.

We have added through the LMSA additional units to the inventory of assisted stock. We should maintain this additional inventory by extending those contracts, something which the administration said that they will not do. I certainly agree that another very important item is the provision of modernization funds for the great majority of projects and many of those in California that have been operating marginally for years need this money in order to continue as viable projects that can continue to provide good housing for their tenants.

Mr. Chairman, in conclusion, I would like to say that the task force is considering the rights of the tenants, the rights of the owners, and we as management agents are trying to bridge that gap. We urge you to delay some of these legislative initiatives until a comprehensive bill next year after the result of our study because we believe it is so important that a housing bill which you have initiated this year, Mr. Chairman, in the Senate be passed by the Congress and signed by the President and there are so many good things for both assisted projects and others in the housing bill that we believe that this is the number one priority.

Mr. Chairman, thank you very much for allowing me to share my views with you today.

[The complete prepared statement of Daniel B. Grady follows:]

CBO, thousands of low income families are at risk of becoming homeless because of privately owned housing disappearing from the federally assisted inventory:

- As of April, 1986, 6,664 HUD-assisted units assisted under the Section 221(d)(3) insurance program were eligible for prepayment of their mortgages.
- By the end of 1987, another 3,796 units will become ripe for unrestricted mortgage prepayments.
- In 1987 alone, Section 8 rental subsidy contracts covering 76,419 housing units will expire. Owners of these units have the right to renew their contract for an additional five years, or to cancel their participation in the Section 8 program and rent the units at market rates without government assistance.
- Between 1985 and 1986, Section 8 rental subsidy contracts for 45,875 units expired, and owners were offered the opportunity to either renew or opt out of the program.
- In 1988, an additional 150,488 Section 8 units could be lost to the affordable housing supply if the owners do not elect to renew.

Altogether, between 1985 and 1988, 272,782 units of housing assisted under the Section 8 program alone may be lost because of potential contract cancellations by private owners.

In FY87, the entire HUD budget will provide only 91,500 additional units of low income housing assistance, or only about one-third of the number of units which could be lost through contract cancellations.

The Homelessness Threat

If these displacements take place, the tenants will have few options. The median income of all tenants in public housing and Section 8 units was just over $6,000 per year in 1983, according to the U.S. Census Bureau. This was about one-third of the national median household income in the same year.

These households are among the "privileged few" very low income renter households by dint of their participation in the federal assistance programs. Section 8 and public housing tenants pay no more than 30 percent of their adjusted income. Tenants in privately owned housing subsidized through the National Housing Act programs (Sec. 221(d)(3), Sec. 236) pay rents which are reduced to reflect the owner's lower interest rate, and rents in these properties are regulated by HUD.

In the general rental market, at least half the renter families with incomes at this level pay more than half their income for rent.

For increasing numbers of families, the consequence of these dry statistics is homelessness. Faced with intolerable rent burdens, families increasingly find themselves "falling out" of the housing market altogether. Overcrowding among low income renters sharing inadequate housing contributes to an even larger and largely undocumented problem of "hidden homelessness".

This is why the hearings you have convened today are so critical. Congress must act decisively to prevent this federally-sponsored homelessness from taking place.

IMMEDIATE STEPS

Enact A Prepayment Moratorium

The first and most important point I want to make to you today is that Congress does not have enough information in its hands to make a responsible, informed judgment about how to protect the public's interest in these jeopardized properties. Other witnesses here today agree--there is a plethora of new task forces, commissions, and study groups struggling to develop facts, analyses and answers to these very difficult questions.

For this reason, my organization urges you to take the first and most difficult step in this process: impose a time-limited moratorium on any prepayments so that Congress and the others interested in this issue can come to a comprehensive consensus agreement about the scope of the problem and solutions which will protect the various interests involved.

The purpose of a moratorium is not to provide a solution to the threat of homelessness from government assisted housing. It is to provide **time for Congress to develop a solution**.

There is ample precedent for taking such a step. Congress since last October has prevented the Farmers Home Administration from accepting any prepayments of mortgages on Section 515 low income rental properties. This Committee has adopted legislation in the banking area which imposes such a moratorium on the formation of new financial entities, for precisely the same reasons: fear that failure to act and allowing events to shape themselves will lead to greater harm than a short-term halt to "business as usual." Congress is really no closer to a solution to the threat of homelessness through prepayment than it was last October when it first adopted the FmHA moratorium.

By enacting a moratorium and directing HUD to carry out a comprehensive policy review process and make recommendations to the Congress expeditiously, Congress would be protecting all tenants in government assisted housing from involuntary displacement by prepayment. This is the heart of the matter. Tenants are in jeopardy. Displacement and homelessness are real threats to low income families. A moratorium on prepayments now would insure that no family would be displaced by actions which Congress in a year would have prohibited by law.

Protect Tenants Who May Be Displaced

Whether a moratorium is enacted or not, sooner or later prepayment of some mortgages will occur. Some owners will opt to withdraw from the federal subsidy programs regardless of the incentives or disincentives Congress, state and local governments put in their path. When this occurs, tenants are likely to be displaced.

Throughout the discussions of prepayment great attention has been paid to the question of preserving the **units** and protecting the **rights of owners**. But there is a third and equally critical area that demands your immediate attention. This is the **protection of tenants.**

The Congress and this Subcommittee must establish the inviolable principle that no tenant may be involuntarily displaced from his or her home through rent increases or conversions after a prepayment without being relocated in a decent, safe and affordable housing unit of comparable size and amenities as the one from which s/he is displaced. No such tenant should be required to pay more than the lesser of the rent paid in the previous property or 30 percent of adjusted gross income.

The establishment of this principle is absolutely critical. Congress initiated a trust with low income tenants 20 years ago. The Congress must act now to confirm that no tenant who qualifies for low income housing assistance shall be displaced as a result of the federal government's permitting owners to opt out of participation in federal housing subsidy programs.

Right of First Refusal

One of the critical elements of a long term approach to the prepayment issue should be to preserve housing resources for continued low income occupancy. A major means by which to accomplish this goal should be to establish a right of first refusal by tenants or nonprofit organizations identified by them to purchase federally subsidized properties from their current owners at the time such owners opt to prepay their current mortgages. Such a right should also be extended to state and local governments when the tenants either fail to exercise their right or waive their right.

A right of first refusal would provide tenants and nonprofit organizations a means by which to secure the long-term affordability and availability of their housing. It would establish a governmental requirement that owners first make these valuable housing resources available to the residents or to organizations who will maintain the properties' use for low income residents. Short of preventing owners from prepaying these mortgages in the first place, a right of first refusal is the most direct and effective means to short-circuit displacement and homelessness.

H.R. 4 as passed by the House Committee on Banking, Finance and Urban Affairs contains provisions which establish a process of negotiation to facilitate purchase of prepaid properties by tenants or nonprofits. But it falls short of granting a right of first refusal. These provisions are certainly better than nothing at all. The National Low Income Housing Coalition worked with its House sponsors to ensure its adoption in the Banking Committee. If the Senate adopts none of our other suggestions, I hope you will accept these provisions in a Conference Committee. However, we continue to believe that unless Congress provides an explicit right of first refusal, many of these negotiations which H.R. 4 requires will result in a lengthy and time consuming process which does not in the end preserve the housing for low income use.

Low Income Housing Preservation Trust Fund

Given the increased value of many of these properties and the low incomes of their residents, a right of first refusal would not provide a realistic alternative to tenants and nonprofits if sufficient funds were not made available at the same time to assist them in purchasing the properties.

We recommend that you create a special Low Income Housing Preservation Trust Fund, the purpose of which would be to provide grants, low interest or variable amortization loans, and other assistance to tenant groups and other nonprofit organizations to facilitate the purchase of prepaid properties. In return for this assistance, tenants and their organizations would have to pledge to maintain the housing for low income use.

Such a Trust Fund would also provide a means by which to assist properties in which owners do not plan to prepay the mortgages, but which need repairs or improvements to extend their useful life.

Money for such a Trust Fund could be obtained from a variety of sources. One obvious one is through the recapture of any subsidy contract budget authority released as a result of mortgage prepayments which cannot be stopped. The Senate should act immediately to adopt the provisions in H.R. 4 which would carry this out. A second source of funding for a Trust Fund is actual repayments on mortgages held by GNMA. Again, language in H.R. 4 accomplishes this goal and should be adopted by the Senate.

There are still other sources which could be tapped to finance such a Trust Fund. Owners who prepay their mortgages and sell their properties could be subject to a "windfall profits tax" the proceeds of which would be directed to the Trust Fund. Such a tax on the proceeds of a sale of a government-assisted housing project would help realize two objectives. One, it would provide a powerful disincentive for owners to prepay their mortgages and sell or refinance their properties. Two, it would recognize the federal government's investment in the property and provide a source of funds for protecting the remaining inventory of low income housing. Such a tax should not be confiscatory but should return to the government a reasonable share of the profits realized from sale of a property whose value to investors was guaranteed and enhanced by government spending over a 20 year period of time.

Tax Law Changes

The Senate should also act to change the current tax treatment of privately owned, federally subsidized properties. Changing the tax treatment of gain realized on sale of low income properties to new owners who agree to maintain low income use could provide a strong incentive by current owners to seek out such buyers. Continued affordability would be helped since the effect of such a tax law change would be to depress the price needed by the owners. A lower selling price would lead to lower debt service and operating costs, and therefore increase the new owner's ability to retain affordable rents.

Other witnesses have presented much more detailed testimony on this issue. Coupled with direct spending from the resources of the Low Income Housing Preservation Trust Fund, such tax-based incentives should be seriously considered as a means to encourage continued low income use in these projects.

LONG RANGE MEASURES

Maintaining Housing Standards

The issue of displacement and homelessness caused by prepayment is a serious question which deserves your serious attention. But the Senate must not lose sight of the thousands of low income housing units in which the problem will not be how to forestall sales and conversioms, but in how to induce continued maintenance and management as decent housing. We all agree that a significant portion of the privately owned assisted housing inventory now has a relatively high market value which puts it under enormous pressure. But we must also recognize that there is a large stock which does not have a high potential for sale or conversion. These properties are also privately owned. They are occupied by low income tenants. Their future is even more dependent on actions which the federal government will take in the next few years.

I urge the Senate to include this side of the picture in its deliberations. H.R. 4 contains a new initiative sponsored by Rep. Barney Frank (D-MA) which would provide low interest rate loans to private owners of subsidized housing to facilitate the repair or replacement of major systems to insure the continued liveability of the housing. In return for the reduced interest rates, owners must agree to preserve the low income use of the property for at least the balance of the mortgage term. Loans to for-profit owners can cover up to 80 percent of the rehabilitation costs, and nonprofit sponsors can receive 100 percent loans. Interest rates would be set at between 3 and 6 percent, but could be lowered to as little as 1 percent. The Senate should endorse this approach and approve this new initiative as soon as possible.

Other changes should also be considered. The new low income housing tax credit adopted last year does apply to existing subsidized properties. But the requirements of the program are out of sync with the realities of many HUD-insured projects. The original Senate version of the tax credit recognized this fact by providing special eligibility requirements for federally-subsidized projects. If the tax Code is to facilitate the preservation of existing low income housing resources by attracting private investment capital changes to the low income housing tax credit must be considered.

Expiring Subsidy Contracts

Along with the problem of deteriorating quality and inadequate funds for repair, thousands of subsidized tenants will be threatened by displacement not because owners decide to leave the programs, but because the government is either unwilling or unable to extend subsidy contract commitments beyond their original term. (Congress the last six years has exacerbated this underlying problem by permitting the conversion of Rent Supplement subsidy units--with 40 year contracts--to Section 8 subsidies, with only 15 year contracts. Not only has this shift endangered thousands of tenants, but it has allowed billions of dollars in already appropriated housing subsidy funds to be recaptured and liquidated--over $400 million in budget authority is being liquidated in the FY87 Supplemental alone.)

The Senate should act immediately to require HUD to renew or re-enter into contracts with all owners now receiving these subsidies, and to require the agency to seek sufficient funds to cover these renewals. Subsidy contracts should be written for a minimum of 15 years.

This is a short-term solution. H.R. 4 contains language which you should consider which carries out this intention. However, in the long run, the Senate faces a much more fundamental and difficult question. Figures already compiled at Sen. Riegle's request show that without some action begin taken now, the refunding of outstanding subsidy commitments will soon overwhelm the meager resources Congress has been prepared to allocate to assisted housing in recent years. Congress is rapidly approaching a point where its choices will be clear and grim: to appropriate funds for expanding the total inventory of assisted households, or to provide funds to prevent the displacement of tenants already receiving subsidies.

Congress must begin to craft legislative solutions which resolve this dilemma. We recommend the creation of a separate component within the Low Income Housing Preservation Trust Fund which would provide funds solely for the renewal and continuation of outstanding subsidy commitments on behalf of qualified low income tenants. This portion of the fund should be financed from an adequate, dedicated revenue source. This revenue stream should be sufficient to finance the ongoing responsibilities of the Trust to maintain subsidy payments to households or owners who remain eligible and are willing to continue participating in the programs.

The alternative to developing this Trust is a disaster. Congress should not allow hundreds of thousands of tenants' futures to depend on yearly appropriations decisions about how many people we can afford to allow to continue to receive subsidies. Nor can owners be left with the uncertainty of a yearly competition for scarce appropriated funds as the basis on which to make business decisions about the use of their properties. I have shared with you the grim statistics that show the depth and breadth of the housing crisis faced by low income people. We cannot afford to wander into a situation where Congress must decide each year between helping those who have never received assistance and those whose housing security is dependent on continued assistance.

The Trust concept separates the two decisions. It is appropriate to decide each year how many additional households should receive additional assistance. We believe that all eligible households should be provided an entitlement to housing assistance. Until such a policy is adopted, however, the low income inventory will grow incrementally. But it is totally inappropriate to force a competition between this decision and the decision to maintain an existing level of assistance. Establishing a Trust to finance these outstanding commitments recognizes the nature of the relationship Congress has created with low income tenants: a trust to help maintain the family's ability to enjoy a decent home at an affordable price.

We have already established this kind of relationship with homeowners. Congress has agreed that homeownership subsidies through tax expenditures should be funded without annual appropriations. Congress simply accepts the responsibility to raise sufficient additional revenue to cover the costs of providing this subsidy. It does not decide that certain owners can no longer take advantage of these subsidies because it is unwilling to appropriate enough money to pay for them. It is time for low income tenants to be granted the same consideration we provide to high income homeowners.

Fostering Non-Speculative Ownership

The growing threat of displacement and homelessness through prepayment of subsidized mortgages is a direct consequence of the mechanism Congress chose 20 years ago to facilitate low income housing development. The use of profit-motivated sponsors to create and own low income housing creates an enormous tension between the public interest in subsidizing the resource and the private interest in disposing of it.

Congress should recognize this problem now and begin to adopt changes in future federal programs which will recognize the flaws which this mechanism contains. Congress should resolve to place a much heavier emphasis in the future on fostering the development of housing through non-speculative ownership models. These should include nonprofit sponsorship, cooperative ownership through limited-equity cooperatives, and other models which leave the ownership interest in property with entities which do not have an incentive to profit by its disposal.

Private sector entrepreneurs can and should be rewarded for their skills. They should be rewarded for whatever risks they take by investing in or assisting in the development of affordable low income housing resources. But these skills and risks do not have to be rewarded by providing control over the ultimate disposition of the housing. They can and should be paid at the time they are performed or undertaken. Congress should work towards a goal of creating housing for low income people which is treated as a trust and maintained as a trust. The last 50 years of housing practice have taught the nation many lessons, some bitter and some sweet. We can provide decent housing if we set our minds to it. We can do so while ensuring tenants that their homes will not be sold out from under them at the first opportunity to show a profit. This is the goal which I urge the Senate to set for itself in the future.

RURAL HOUSING

Some 350,000 units financed under Section 515 rural rental housing loans will be eligible for prepayment at some point. The most immediate problem is that loans made before Dec. 21, 1979, may be prepaid at any time, once a congressionally-mandated moratorium expires. The pre-79 loans comprise about 52 percent of the overall 515 stock. Prior to the establishment of the moratorium, over 5,000 units, including about 1,250 in California, were lost in the period of 1984-86. Virtually every state in the Union has loans prepaid during those three years.

Loans made after the Dec., 1979, date are subject in most cases to a twenty year low and moderate income use restriction. According to the Housing Assistance Council, over 30,000 units will be eligible for prepayment by the year 1999 and for several years thereafter a similar number may be removed from the program.

H.R. 4 establishes the 20-year use restriction for pre-'79 projects and a federally financed program to allow nonprofits and public bodies to purchase projects from owners who wish to prepay. However, because H.R. 4 is based on the notion that a 20-year use restriction is an adequate response to the prepayment problem, it simply postpones the crisis.

Funding for 515 grew rapidly in the 1970's. Beginning in 1973, and every year thereafter, appropriations for rural rental housing units were increased markedly. Under H.R. 4 we will begin to lose these units, in increasing numbers, in 1993. So, while H.R. 4 is a good start, it does not go far enough in the effort to permanently retain low income housing.

The National Rural Housing Coalition is recommending, in a statement submitted for the record, a different approach. NRHC's proposal would require any project eligible for prepayment to be offered first to a public or private nonprofit which would permanently manage the housing for low and moderate income residents. If at the end of a year's time the nonprofit does not exercise this right, the owner is free to do as he or she pleases.

Using the resources of the Rural Housing Insurance Fund (RHIF)to purchase existing housing and maintain tenant rents is far cheaper and better policy than to attempt to replace the 350,000 units currently occupied by families with annual incomes of less than $9,000.

Thank you for the opportunity to share our views on these important matters. I will be happy to answer any questions which you may have.

TESTIMONY OF
DANIEL B. GRADY, CHAIRMAN
THE NATIONAL ADVISORY COUNCIL
OF HUD MANAGEMENT AGENTS

BEFORE THE SENATE
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

Mr. Chairman, members of the Committee, my name is Daniel Grady. I am the Chairman of the National Advisory Council of HUD Management Agents and testifying today on behalf of that organization. I am also the President of Monfric, a firm based in San Diego, California which has been engaged in the development and management of assisted housing since the late 1960's.

I would like to express my appreciation for being permitted to share our views with you today.

As further introduction, the National Advisory Council of HUD Management Agents is an independent body of 46 property management firms and associations who together manage the majority of all privately owned government assisted housing in the country. We work together to preserve the existing stock of federally assisted housing and to improve the quality of management of that housing. We are in constant dialogue with the regulatory agencies on procedures, practices and regulations that will make housing work better. We also try to practice what we preach.

Some of our members are fee managers who manage projects in which they have no ownership interest. Some manage their own projects while others, such as myself, do both. In our daily business we, therefore, deal with and recognize the interests of both owners and tenants.

The National Advisory Council approximately three years ago established a preservation committee to study the problem of maintaining the stock of privately held government assisted housing. This early effort was expanded last year and the study was broadened to also include problems resulting from prepayment of mortgages, expiration of project based subsidies such as Loan Management Set Aside programs and other factors adversely affecting the preservation of this housing stock.

In February of this year, the Council established a Task Force consisting of knowledgeable members of the housing industry, representatives of tenant organizations and a representative group of its own members. The Task Force held its first meeting in April defining issues and establishing subcommittees to study in depth the following issues:

Owner Incentives
Expiring Subsidy Contracts
Prepayment of Existing Mortgages
Tenant Impact
State and Local Initiatives

As our subcommittees progress with the study, they are also focusing on the impact that each proposed solution might have on the welfare of the tenants and their ability to continue to enjoy living in a safe and desirable environment. The final report of the Task Force is due in late October. The Council appreciates the support which this Task Force received from the staffs of the Congressional subcommittees and Assistant Secretary Demery and his staff.

We urge that the Congress await that report as well as the results of similar efforts undertaken by other groups before it enacts comprehensive legislation on the preservation of assisted housing stock.

Although much attention has been focused on the impending possibility of prepayment of certain mortgages such as 221(d)(3), BMIR's and 236's, the problems of preservation are broader and much more complicated. Attention must also be focused on those projects which need major rehabilitation and do not have the resources to undertake such work. Attention must also be given to those projects which are receiving Loan Management Set Aside Section 8 assistance, and cannot survive without such assistance. Some attention must also be given to the plight of the projects that need an influx of new capital which could be provided upon sale or resyndication but cannot because of recent changes of tax laws.

A comprehensive HUD survey indicates that of the current universe of some [illegible] projects, (BMIR and 236's) 80% are ineligible to prepay their mortgages on their 20th anniversary. HUD has further estimated that of those that are eligible to prepay, [illegible] or 14% of the total inventory "will prepay". Of that total, over 40% are located in HUD's Region 9 with the overwhelming majority in my own state of California.

These projects that HUD has placed in the "will prepay category" are generally smaller projects, under 100 units, well located, well managed and in a superior condition. Many of these projects are still held by the original developer who has nurtured them over these past 20 years. Some have recently been sold to buyers who invested substantial cash amounts and expect to receive a reasonable return on their investment.

An example of that type of project is Escondido Apartments located in a suburb of San Diego. The project was sold in 1986 by the original developers to an individual who purchased the project for investment at a cost of $2,116,000 or $23,000 a unit. The outstanding mortgage balance was $11,902 per unit. The purchaser paid the difference, a little over $11,000 in cash. Under the provisions of the regulatory agreement, the new owner may only receive a cash dividend of some $92.00 per unit per year or 8/10ths of 1 percent return on his investment.

HUD's rent formula limited Escondido Apartment rents at the time of sale to $235 basic rent and $288 so-called market rent. The project is occupied by senior citizens with households of one or two persons. The project will be eligible for mortgage prepayment in February, 1992.

Why did the original developers sell? Primarily, Mr. Chairman, because he also was limited to an annual return of $92.00 on his locked in equity of $11,000 per unit. The project had been depreciated and the original owner was paying income taxes on "phantom income" many times in excess of the $92.00 per unit per year he was receiving. ("Phantom income" is taxable income which does not produce cash for the owner because the cash issued for principal payments is held in replacement reserve or contributed to residual receipts.) Why did the new owner buy? Because he was able to start a new depreciation schedule and could buy a project at a substantial discount from the cost of a similar apartment, unfettered by federal regulations. He knew that in 1992 he could prepay the mortgage and/or increase his return to an acceptable level.

In the meantime, what was the effect on the tenants? The original developer continued to manage the project and maintain its high standards. The rents will probably increase somewhat because of the peculiar reassessment policies for property tax purposes which exist in California pursuant to Proposition 13. Except for that, the tenants will continue to live in a very pleasant environment and well maintained apartment units at extremely low costs. Under the Section 236 regulations, an individual of 62 years of age or older with an annual income not exceeding $17,550 is eligible to move into Escondido Apartments. If that tenant were asked to pay 30% of his or her income towards rent, the rent would be $438 per month. Because the so-called market rent is limited to $288, the tenant will not pay more than $288, approximately 19% of his or her income.

We believe that adequate inducements such as a modest increase in rent and allowable return on equity would be cost effective and would not impose an inordinate burden on the tenants. This could convince owners such as the new owner of Escondido Apartments to continue to operate their projects under restrictions and oversight of HUD and keep them in the government assistance inventory.

Our Task Force is studying these issues and will propose solutions which will hopefully blend the government's interest, the owner's desire for a reasonable return on his investment and the tenants' need to have rents within their ability to pay.

Now, Mr. Chairman, I wish to call your attention to another group of projects, many of which also exist in California. These are the Section 236 and BMIR projects which are not located in the better suburban areas and have not attracted tenants whose incomes are in the upper range of the eligibility criteria. They are projects which can only survive with the help of the Loan Management Set Aside subsidies which most began to receive after 1975. These contracts are for a term of 15 years except those entered into in 1984 or later which are limited to five years. These contracts will terminate as early as 1989. The Administration has announced that it will not extend such contracts. Many of these projects will default and be foreclosing with the resulting tenant dislocation and upheaval. The cost to the government in dollars and in social disruption will, in many cases, be far greater than the cost of extending the set aside contracts. Certain projects which are not originally built to be part of the assisted stock but rather to be market rate 221(d)(4)'s, 231's or even 207's were, in fact, added to the assisted housing stock because of these LMSA contracts. Unless these contracts are extended beyond the termination date there will be a loss of assisted housing stock and dislocation of tenants which might be greater than that resulting from projects which prepay their mortgages. An opportunity exists to save these projects and increase the assisted housing stock at a modest cost by inducing owners to continue to operate them as assisted projects for an extended period. Our Task Force will give detailed recommendations on this problem which will include an estimate of cost and the benefits to both the government and the tenants.

A third group of projects are those that fall in the category that HUD calls "likely to prepay". Many of these projects are operating satisfactorily, do not need large amounts of subsidy beyond those offered by the basic BMIR or 236 programs but would be marginal projects if operated as conventional apartments. Many owners would agree to extend the lock-in period if they could increase their return and could be protected from the taxation burden imposed upon them by "phantom income".

Currently HUD can, within its authority, negotiate with an owner and provide economic inducements for BMIR projects. This was done successfully in the case of Washington Manor in New Jersey. We believe that small technical changes to legislation can provide the same authority for 236 projects. Revisions to the Tax Act might provide to existing owners who agree to extend their lock-in period, benefits similar to those available to new owners who purchase existing projects. Again our Task Force will provide specific recommendations for that type of project.

Finally, Mr. Chairman, I would like to call your attention to an area where assistance is most needed. This is that vast group of projects, maybe as high as 50% of the total inventory of privately owned assisted projects, that lies between those extremes that HUD calls "will prepay" and those that have no potential for survival without additional project based subsidy. Many of these projects have operated marginally for years. Their markets might have shifted and now, major repairs are necessary. These projects require an infusion of additional capital for modernization in order to continue to operate as a viable resource. We believe that such funds must be provided at a reasonable cost and that a balance must be struck between income to be received through small increases in rents, subsidy of interest rates for modernization loans together with incentives for owner investment such as relief from excessive tax burdens and reasonable increases in permitted return. Our Task Force is also addressing these complex issues.

Mr. Chairman, we believe that an entire package of tools must be developed to preserve the existing stock. The federal government in cooperation with the industry and tenant organizations can identify and provide those tools in timely fashion. The National Advisory Council has worked on this matter in line with the stated policy of the Council. If I may quote from our policy on preservation of the existing stock of assisted housing,

> "It is therefore the policy of the National Advisory Council of HUD Management Agents that preservation of this housing should be pursued as a matter of national priority and to that end, the National Advisory Council will support those preservation efforts that cause industry and government to work in harmony towards reducing the federal cost while making available to industry, economic incentives that are commensurate with their risks to be taken."

In conclusion, Mr. Chairman, I would like to comment briefly on House bill H.R. 4. First, the National Advisory Council applauds the efforts of both houses to ensure passage of a housing authorization bill, the first in many years, in this session of Congress. While we understand that differences need to be ironed out between H.R. 4 and S. 825, we commend both houses for their efforts. H.R. 4 contains a number of provisions which we feel can and should be supported. In particular we wish to refer to your attention the so-called Capital Improvements Loan Program, Section 171 of the bill which provides funds for necessary improvements for many of the projects we are focusing upon this morning. Mr. Chairman, the Council has for better than four years supported this concept. Members of the Advisory Council, individually and collectively, have provided input into the development of this program. We believe it to be a sound workable initiative.

Other provisions of the bill such as Section 145 and Section 328 providing for direct loans to troubled projects would be of assistance in addressing the preservation issue. We cannot, however, support the amendments which have been added to H.R. 4 which would impose limitations on the rights of owners to prepay the mortgages, rights which were granted in the original contracts executed between owners and the government (Section 161). Even the right of first refusal we believe is unworkable and would place the owners under untenable conditions.

Although we often support and agree with the authors of this amendment, we believe that if this legislation is enacted it would lead to extensive litigation. Because it is so important in our view that a housing bill be passed by Congress and signed by the President this year, we urge you to defer consideration of this and other worthwhile provisions dealing with preservation not presently included in S. 825 until next year when Congress, tenant organizations and industry can work together to reach solutions that would be less costly in dollars, avoid deterioration of housing stock and protect the interests of tenants and the rights of the owners. If we accomplish this task, we will be able to look back and say that we did our job well.

Mr. Chairman, we applaud you and your Committee for these hearings. You can rest assured of our cooperation and our support in this position. Thank you again, Mr. Chairman, for permitting us to share our views with you and please call on us if we can be of further assistance.

Senator CRANSTON. Thank you very much, Mr. Grady.

I want to thank our final witness also for coming all the way from California, Deane Ross.

STATEMENT OF DEANE EARL ROSS, PRESIDENT, ASSOCIATED FINANCIAL CORP., PACIFIC PALISADES, CA

Mr. ROSS. Mr. Chairman, I'm president of Associated Financial Corp. and have actively participated in the HUD assisted low income housing field since the late 1960's. We serve as general partner of Partnerships owning almost 50,000 apartment units serving low income families on a national basis. That consists of approximately 360 projects in 35 States.

I welcome the opportunity to present to you our perspective regarding the actions necessary to assist the preservation of our Nation's important federally assisted housing inventory.

Most of our Nation's housing inventory is owned by private investors who, as in the case of the HUD assisted housing, acquired their ownership interests primarily for tax incentives.

This tax incentive was created and supported by a continuing series of congressional acts encouraging private sector participation.

PROGRAM LIMITATIONS PLACED ON RENT AND INCOMES

Program limitations were placed on rent and the incomes of tenants which effectively curtailed economic benefits for 20 years from the date the property was built. With tax benefits compromised by the 1986 tax law changes, owners will find economically sound methods for disposing of their investments.

Owners have no economic option other than to remove the properties from the subsidized housing inventory, increase the rents, and therefore their net income.

Where projects are located in markets which do not permit an increase in rents, those owners have little incentive to invest additional dollars for physical needs. Thus, the properties may deteriorate, resulting in uninhabitable units, and the housing may ultimately be lost by foreclosure.

To change direction we must develop alternative economic incentives for private owners to continue the present usage or to transfer ownership of the properties to new owners who have adequate economic incentives to provide the necessary resources to preserve the property as low and moderate income housing.

First and foremost, Mr. Chairman, Congress must mandate a clear policy that preservation of the existing housing stock is our national housing policy. Simultaneously with expressing this mandate, Congress must enact the necessary legislation to cause the preservation to be achieved. The mandate by itself will not do the job.

It will cost the Government far less in the next decade to use limited resources to preserve what exists than it would cost to ultimately build expensive replacement housing.

The needs of each project are unique. A variety of new tools must become available as the foundation of a nationwide program. This program must begin the process of moving the inventory into ownership entities that will cause the housing to be protected under a new preservation umbrella of Federal policy.

OWNERS FACING TAX LIABILITY

Current owners of properties under existing income restrictions are faced with an overhanging tax liability. If they sell to a new ownership entity, they will immediately recognize a gain on their negative basis, plus any cash received. If they were willing to receive no cash at all, not a nickel, owners would still realize a tax liability without the sale generating the funds to pay the tax. This, in itself, forces the marketizing of the property to generate cash to pay the tax due on disposition—the course that will be pursued if no other alternative is available.

Now, Senator, the original 1969 legislation that enacted the incentives to produce this housing anticipated the preservation issue and legislatively provided for its solution. Congress enacted an exit program for owners under section 1039 whereby the low income occupancy of the housing would be preserved. Section 1039 provides that an owner can sell to a suitable nonprofit or tenant group and reinvest the proceeds within a limited time period into another project without tax consequence. That's already on the books. Unfortunately, such reinvestment opportunities no longer exist. This option, without congressional modification to meet today's circumstances, is of little value.

Reestablishing this incentive is one extremely effective method to facilitate the preservation of a significant portion of the threatened low income housing stock.

The proposed revision of section 1039 would provide that a "Qualified Housing Project"—and that's defined as those serving defined levels of low income tenants who agree to sell under an "Approved Disposition" to specific types of owners that agree to preserve the low income use would be entitled to pay tax only on the amount of cash received in the transaction. The sale must be approved by HUD, FmHA, or the appropriate state agency. No existing tenants may be displaced.

I believe this suggestion preserves the spirit and intent of Congress when the provision was initially enacted. It makes workable and effective that which present conditions have made useless.

This revision of section 1039 will provide a positive incentive to existing owners of low income housing projects to opt-in and sell projects to new entities committed to low income housing preservation.

From the point of view of many passive owners of HUD properties, the uncertainty of the overhanging tax liability is sufficient cause to sell the property to a new preservation owner. Investors will be motivated to accept an immediate known favorable result and the elimination of future tax liability rather than remain as owners facing the uncertainties of tomorrow's marketplace.

It is critical that Congress couple its passage with a "sunset" provision of 3 years from date of enactment. Thus, project owners would have a reasonable time to opt-in or assume the risk that future market conditions might offer a signficantly better option.

Many will not gamble that 5 or 10 years later a better result can be achieved.

Some owners of highly valuable property may elect not to take advantage of the revised section 1039. However, even in these cases, we might achieve an effective preservation compromise—and this really goes to the point of the project in Escondido which I just heard about at the table here—by a program that offers existing owners new HUD financing to replace the existing HUD debt on terms more costly than the existing debt, but less costly than new market rate financing. In return for this favorable refinancing, the owners would agree to continue the property's use under a new HUD regulatory agreement that would limit occupancy to tenants at or below 80 percent of median income. There should be adequate protection against the displacement of existing tenants for a specified time period. Owners opting for this refinancing would have no restrictions on cash distributions or secondary financing.

The result is considerably less disruptive to the existing tenants than marketizing, and the housing resource is preserved to still serve an important affordable housing need of the community.

There is a continuing need for capital to maintain the viability of the projects, and this goes to the point that's already been mentioned by other speakers—owners willing to continue in an ownership role are unable to provide this necessary capital. The 1986 Tax Act has created a scenario in which investors concerned with preserving the property have no economically logical method of providing the capital to do the job.

Existing owners who agree to extend the use of the property as low income housing and commit additional capital for physical needs should be entitled to continued use of losses and tax credits on needed rehabilitation expenditures, regardless of the length of the ownership. It is the preservation of the physical and economic integrity of the projects which are vital, not some arbitrary standards such as the length of time of ownership.

We should enact legislation to facilitate ultimate tenant housing ownership with clear, enforceable requirements for continued use as low income housing regardless of future ownership changes. Thus, we will have completed the logical social and economic cycle of placing control of the housing directly in the hands of those with the greatest concern for its preservation, and, Senator, the suggested revisions to section 1039 clearly reflect that conviction of ours.

Though entering the turbulent waters of revisiting the changes made in the 1986 tax act may seem ill-advised to some, it is totally illogical to let stand unquestioned a set of tax laws which undermine the welfare of the housing we seek to preserve. Tax policy literally destroyed our housing policy.

Now, tax policy must be redefined to be compatible with an invigorated national housing policy.

NEED NEW TAX CREDIT LEGISLATION

The enactment of these new proposals and enacting changes in the recent tax credit legislation to make tax credits more effective will cause a positive response to preserve the housing.

The same private sector spirit and drive which responded to an earlier congressional call to produce this housing based on tax incentives is certain to similarly respond to a congressional call to preserve the same housing based on similar incentives.

It is now up to Congress to express its will by stating that preservation is our national housing policy. Provide us a mandate and the tools, and the goal will be achieved.

Mr. Chairman, for the record and your information, I am submitting herewith a more detailed statement on preservation prepared by Bruce Rozet, Chairman of our company.

[The complete prepared statements of Mr. Deane Earl Ross and Bruce Rozet follow:]

TESTIMONY OF

DEANE EARL ROSS, PRESIDENT

ASSOCIATED FINANCIAL CORPORATION

BEFORE THE SENATE SUBCOMMITTEE ON HOUSING & URBAN AFFAIRS

COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

June 5, 1987

Mr. Chairman and Members of the Subcommittee:

My name is Deane Ross. I am President of Associated Financial Corporation and have actively participated in the HUD assisted low-income housing field since the late 1960s. We serve as General Partner of Partnerships owning almost 50,000 apartment units serving low-income families on a national basis.

I welcome the opportunity to present to you our perspective regarding the actions necessary to assist the preservation of our nation's important federally assisted housing inventory.

Most of our nation's housing inventory is owned by private investors who, as in the case of the HUD assisted housing, acquired their ownership interests primarily for tax incentives.

This tax incentive was created and supported by a continuing series of Congressional acts encouraging private sector participation.

Program limitations were placed on rent and the incomes of tenants which effectively curtailed economic benefits for twenty years from the date the property was built. With tax benefits compromised by the 1986 tax law changes, owners will find economically sound methods for disposing of their investments.

Owners have no economic option other than to remove the properties from the subsidized housing inventory, increase the rents, and therefore their net income.

Where projects are located in markets which do not permit an increase in rents, those owners have little incentive to invest additional dollars for physical needs. Thus, the properties may deteriorate, resulting in uninhabitable units, and the housing may ultimately be lost by foreclosure.

To change direction, we must develop alternative economic incentives for private owners to continue the present usage or to transfer ownership of the properties to new owners who have adequate economic incentives to provide the necessary resources to preserve the property as low and moderate income housing.

First and foremost, Congress must enunciate a clear mandate that the keystone of our national housing policy is the preservation of the existing housing stock. Simultaneously with expressing this mandate, Congress must enact the necessary legislation to cause the preservation to be achieved.

It will cost the government far less in the next decade to use limited resources to preserve what exists than it would cost to ultimately build expensive replacement housing.

The needs of each project are unique. A variety of new tools must become available as the foundation of a nationwide program. This program must begin the process of moving the inventory into ownership entities that will cause the housing to be protected under a new preservation umbrella of federal policy.

Current owners of properties under existing income restrictions are faced with an overhanging tax liability. If they sell to a new ownership entity, they will immediately recognize a gain on their negative basis, plus any cash received. If they were willing to receive no cash, owners would still realize a tax liability without the sale generating the funds to pay the tax. This, in itself, forces the marketizing of the property to generate cash to pay the tax due on disposition -- the course that will be pursued if no other alternative is available.

The original 1969 legislation that enacted the incentives to produce this housing anticipated the preservation issue and legislatively provided for its solution. Congress enacted an exit program for owners under Section 1039 whereby the low-income occupancy of the housing would be preserved. Section 1039 provides that an owner can sell to a suitable non-profit or tenant group and reinvest the proceeds within a limited time period into another project, without tax consequence. Unfortunately, such reinvestment opportunities no longer exist. This option, without Congressional modification to meet today's circumstances, is of little value.

Re-establishing this incentive is one, extremely effective method to facilitate the preservation of a significant portion of the threatened low-income housing stock.

The proposed revision of Section 1039 would provide that a "Qualified Housing Project", those serving defined levels of low-income tenants, who agree to sell under an "Approved Disposition" to specific types of owners that agree to preserve the low-income use would be entitled to pay tax only on the amount of cash received in the transaction. The sale must be approved by HUD, FmHA, or the appropriate state agency. No existing tenants may be displaced.

I believe this suggestion preserves the spirit and intent of Congress when the provision was initially enacted. It makes workable and effective that which present conditions have made useless.

This revision of Section 1039 will provide a positive incentive to existing owners of low-income housing projects to opt-in and sell projects to new entities committed to low-income housing preservation.

From the point of view of many passive owners of HUD properties, the uncertainty of the overhanging tax liability is sufficient cause to sell the property to a new preservation owner. Investors will be motivated to accept an immediate known favorable result and the elimination of future tax liability rather than remain as owners facing the uncertainties of tomorrow's marketplace.

It is critical that Congress couple its passage with a "sunset" provision of three years from date of enactment. Thus, project owners would have a reasonable time to opt-in or assume the risk that future market conditions might offer a signficantly better option. Many will not gamble that five or 10 years later a better result can be achieved.

Some owners of highly valuable property may elect not to take advantage of the revised Section 1039. However, even in these cases, we might achieve an effective preservation compromise by a program that offers existing owners new HUD financing to replace the existing HUD debt on terms more costly than the existing debt, but less costly than new market rate financing. In return for this favorable refinancing, the owners would agree to continue the property's use under a new HUD Regulatory Agreement that would limit occupancy to tenants at or below 80% of median income. There should be adequate protection against the displacement of existing tenants for a specified time period. Owners opting for this refinancing would have no restrictions on cash distributions or secondary financing.

The result is considerably less disruptive to the existing tenants than marketizing, and the housing resource is preserved to still serve an important affordable housing need of the community.

There is a continuing need for capital to maintain the viability of the projects. Owners willing to continue in an ownership role are unable to provide this necessary capital. The 1986 Tax Act has created a scenario in which investors concerned with preserving the property have no economically logical method of providing the capital to do the job.

Existing owners who agree to extend the use of the property as low income housing and commit additional capital for physical needs should be entitled to continued use of losses and tax credits on needed rehabilitation expenditures, regardless of length of ownership.

We should enact legislation to facilitate ultimate tenant housing ownership -- with clear, enforceable requirements for continued use as low-income housing regardless of future ownership changes. Thus, we will have completed the logical social and economic cycle of placing control of the housing directly in the hands of those with the greatest concern for its preservation.

Though entering the turbulent waters of revisiting the changes made in the '86 Tax Act may seem ill-advised to some, it is totally illogical to let stand unquestioned a set of tax laws which undermine the welfare of the housing we seek to preserve. Tax policy literally destroyed housing policy.

Now -- Tax Policy must be redefined to be compatible with an invigorated National Housing Policy.

The enactment of these new proposals, and enacting changes in the recent tax credit legislation to make tax credits more effective, will cause a positive response to preserve the housing.

The same private sector spirit and drive which responded to an earlier Congressional call to produce this housing based on tax incentives is certain to similarly respond to a Congressional call to preserve the same housing based on similar incentives.

It is now up to Congress to express its will by stating that Preservation is our National Housing Policy. Provide the mandate -- the tools -- and the goal will be achieved.

Mr. Chairman -- for the record and your information, I am submitting a more detailed statement on Preservation prepared by Bruce Rozet, Chairman of our company.

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Deane Earl Ross
President

COMMENTS ON H.R. 4

Subtitle "C" Multifamily Housing Preservation Loans.

This section is designed to provide a capital fund to assist in maintaining the physical and financial integrity of existing low income housing projects. In many respects, it is similar to the flexible subsidy program enacted approximately ten years ago. The experience with the flexible subsidy indicates that the program has proven itself to be very beneficial to the housing stock.

Thousands of units are habitable today as a result of that program. HUD has avoided hundreds of millions of dollars of defaults as a direct result of this one program. Because of aging and usage, there will always be a necessity for funds to maintain and upgrade existing low income housing. Rarely will such funds be readily available in the more normal financial markets without requiring the tenants to pay significant rent increases. Therefore, the proposed Subtitle "C" program, though modest in actual dollars, could serve to preserve and protect a valuable segment of the low income housing stock and, probably in the long run, save the government far more than its direct cost.

One of the experiences with the flexible subsidy program involved the capital contributions by the owners. This permitted the available government capital to be supplemented by profit capital, thereby increasing the amount available for needed maintenance. Similarly, H.R. IV calls for a 20% equity contribution by investors to assist the preservation process.

Since there is now little or no tax benefit to existing owners, it is doubtful that they will readily commit additional funds without incentives to do so, even though the result might be to improve the physical status of the property.

It is probable that the equity capital contribution would then be waived by HUD in many instances. It would be preferable to design this program to permit this loan to qualify for the rehabilitation tax credit of 9%, and in turn increase the private sector contribution to at least 50% of that being provided by the government. This requires an incremental change in the tax law, but, whether it is directly addressed or not, it will still impact the effectiveness of Subtitle "C".

Subtitle "B" Multifamily Housing Management and Preservation.

The intent and most of its language should be applauded in that it places preservation of low income housing in the forefront of national housing policy. For the most part, there is no quarrel with its language, and we urge that a similar section be placed into the Senate Bill. This section of the Bill is noteworthy in that it instructs the Secretary of HUD to do some indepth evaluation of the problems precipitated by prepayment of existing mortgages and report financing requirements to Congress within a specified period of time.

The language, however, doesn't go far enough in requiring HUD to take steps necessary to preserve the housing. It gives the Secretary the right to act to preserve low income housing, but does not make it mandatory for the Secretary to take such actions. It should impose an obligation to act upon the Secretary. In effect, the present language leaves the existing low income housing stock vulnerable to the same type of dispute and uncertainty that characterizes the present national position. To the extent that HUD decides to close its eyes and permit properties to be removed from the low income housing inventory by ill-advised sales, conversions, mortgage payoffs, and other possible actions, the purpose of this section is subverted and the inventory is lost. That has clearly been the circumstances during the past several years.

This entire section would be much stronger if specific programs were provided that the Secretary could use to meet the objectives and goals of preservation. For example, "rewriting" the existing HUD 221(d)(3) and/or 236 mortgages so that the owner pays an increased interest rate to HUD (in lieu of marketizing), and would be permitted to increase rents under certain conditions. Owners would be allowed unlimited cash distributions and refinancings provided the properties were maintained for tenants whose income was no more than 80% of median, and that the tenants paid no more than 30% of their income in rent. If included as part of the Senate Bill, this type of specific program could serve as a defined tool to be used by HUD to avoid mortgage prepayments, while at the same time providing additional income to the government to be used as a further buffer resource against unavoidable prepayments.

While the statements of policy and goals of preservation are admirable, there is concern that the administration process will allow the inventory to slip away while Congress debates, in oversight committees, the propriety of HUD's actions in carrying out the mandate of Congress. To the extent that it is possible to strengthen Subtitle "B" in the Senate Bill, this section of the bill should be strongly supported.

INVESTOR EXPECTATIONS

It has been suggested that the movement of segments of the subsidized housing stock to the open market could constitute a "windfall" to investors. The term "windfall" is defined as an unexpected, positive return.

Under the circumstances, it would be appropriate to review the expected, anticipated rewards investors had been led to expect when they provided capital to help create and maintain low income housing.

The basis for private sector capital's investment in low income housing was to secure concrete tax benefits, which would serve to offset other taxable income and lower the amount of tax currently paid. And, in lieu of a current cash return, long term ownership from these properties could provide capital gains at some point in the future. The long term opportunity, in fact, was provided for by the institution of "Regulatory Agreements". These agreements assured that capital would remain invested for a minimum of twenty years, at the end of which, at the option of the investor, the HUD mortgage could be prepaid, and the housing could enter into the regular, non-subsidized housing market. Had it been the intent of Congress that there be no opportunity for capital appreciation, then the law and the regulatory agreements would have been drafted differently.

The Government never guaranteed any investment results, either in terms of long term appreciation, limited distributions, or tax benefits. It did hold out to investors the right to a climate under which the goals of that housing legislation could he achieved, and, in this manner, forged a unique partnership between the private and public sector to provide low income housing.

Recently, the Government, in the Tax Reform Act, significantly reduced or eliminated the very Tax benefits that were the basis for private sector involvement in this socially worthy investment. The Government action itself provided a disincentive to maintain existing low income housing for present usage by siphoning the tax incentives from the investment.

Senator Cranston, in his opening remarks, has outlined the goal that..."any solution should provide equitable treatment for the developers and owners of low and moderate income housing". It is important for us to note that the concept of "windfall", which has been advanced at these hearings, is an emotionally charged term and is divisive. It is a term which conjures up the image that someone is getting "something for nothing". The objectives of the proposed legislation, which is to continue that unique long term partnership between the Government and the private sector, should not be divisive. It should rather seek the continuation and enhancement of this once successful relationship. This cannot be done by continuing to strip away the very rationale that drew private investment into the housing field. It must rather seek to set in and provide those incentives which are both fair, i.e., consistent with the basis by which these investors were induced to invest originally, yet should not be so cost ineffective that we are "giving away the store".

As we have observed in our discussion, the Government has succeeded in creating a climate, through the labyrinthine provisions of Tax Reform, to precisely provide the rationale for every reasonable owner of low cost housing to convert that housing into market rents when their regulatory agreements expire. The bill has taken away all of the incentives and retained all of the disincentives. The task is not to "look under the bed" to see that no one is getting a windfall. It is, more precisely, to fashion those laws and rules which will, at the lowest social cost, provide a way to maintain the housing stock for low and moderate income families.

It is our belief that the introduction of a moratorium to prevent conversion of low income housing is not a rational solution to the goals enumerated. Primarily because such a fiat on the part of the Government only accentuates some of the negative environment that has come about as a result of the Tax Reform Act. It will be difficult, if not impossible, to secure an effective partnership with private sector capital when you keep changing the rules in the middle of the game.

The moratorium, furthermore, is not needed. The number of units becoming eligible within the next two years is minuscule compared to the total inventory. The largest bulk of units will become eligible only three years hence. It is more urgent that we take this intervening time to refashion and strengthen the partnership of private sector capital and government in a positive and constructive way. In this way we can insure that there is sufficient incentive to maintain the housing stock for those in our nation who are economically disenfranchised.

PRESERVATION OF AFFORDABLE HOUSING

A NATIONAL HOUSING POLICY

BY

A. BRUCE ROZET

CHAIRMAN OF THE BOARD

ASSOCIATED FINANCIAL CORPORATION

PRESERVATION OF AFFORDABLE HOUSING
A NATIONAL HOUSING POLICY

Despite massive programs legislated in the 60's and 70's, designed to increase the supply of low and moderate income housing, we are today faced with a housing crisis greater than at any time since WWII. We have allocated hundreds of billions of dollars for interest and rent subsidies to build a basic low income housing inventory, and we are on the verge of seeing it move out of the reach of the tenants it was built to serve. At a time when administration policies and budget constraints have all but eliminated the availablity of funds to build additional housing, we are ironically faced with the prospects of losing much of what we have paid so much to build.

First and foremost, Congress must enunciate a clear mandate for preservation of our existing housing stock as a national policy and simultaneously enact the necessary legislation to assure that we start to move in the direction of preserving housing as a national resource.

A national housing policy, with preservation as its cornerstone, is not just an emergency measure designed to contain a few local brush fires. It is an economical and practical approach to assuring an adequate supply of affordable housing for all American families. It will cost the government far less in the next decade to use our limited resources to preserve what exists than it would cost to attempt to build replacement housing.

A well designed preservation program will, in the long run, increase the supply of affordable housing by arresting the eroding influence of deterioration and abandonment which claims thousands of rental units from our housing stock each year. Of even greater importance, we must curtail the process of gentrification which wrests existing housing from the reach of lower income families through escalating rents and condiminium conversion to serve middle and upper income families. The forces of deteriorization and marketization have reduced our stock of affordable housing by far greater numbers than all of the housing units we have built under Federal programs in the past 20 years. By taking immediate action in the form of new legislation we can arrest this accelerating trend toward a declining affordable housing stock.

To effectively design the necessary legislative initiatives we have to confront some of the realities of the present low and moderate income housing stock. We tend to identify that stock as primarily the rental housing built under one or more federal programs since the late sixties and benefiting from some form of federal subsidy - interest reduction or rent supplement. Though this constitutes the largest, easiest indentifiable portion of the inventory, there is an even larger inventory of rental units serving families with incomes below 80% of the median.

Senator **Cranston**. Thank you very much for your very interesting testimony and that interesting proposal.

A number of different solutions have been proposed, ranging from what Deane Ross just suggested to prohibiting prepayment all the way to offering owners lucrative incentives to retain these units for low income use.

SUGGESTIONS ON AREAS OF COMPROMISE

I would like to ask each of you to just very briefly comment—what are the most promising areas of compromise that you see? What protections would you suggest to ensure that an incentive approach would be cost effective and would be targeted to those owners who actually plan to remove units from low income housing stock? Any brief suggestions you may have, and if you want to supplement your thoughts in writing I would appreciate that.

Mr. **Grady**. Senator, I believe that the incentives could be very cost effective and that has been stated by other speakers. Primarily, we need to have some incentives in the tax area and in increasing the return. There's no question that it will cost some money. However, it is possible in the projects that we are talking about now—the 236 and the BMIR—that we're dealing generally with a more affluent type of tenants, particularly in those projects that are eligible for prepayment to slightly increase the rents and to bring them to the point where all tenants would be paying 30 percent of their income in rent and provide this incentive in the form of additional return.

That, coupled with a tax incentive, should be given to an owner who retains his project for an additional period of time without having to go through the sale of a project—a tax incentive that would be similar to a new owner buying it, but without doing the sale, would be an adequate compromise.

Senator **Cranston**. Do you have any comment on Mr. Ross' suggestion?

Mr. **Grady**. I think that Mr. Ross' suggestions are good, and I certainly would want to discuss them with him more in detail but I think that it is a step in the right direction.

I believe, however, that the most important thing would be to offer an owner, who has been experienced in operating the project and who has invested a long time, who has fully depreciated, a tax incentive to continue ownership, if he agrees to maintain the project and agrees to an extended lock-in period, without having to go through the sale.

Senator **Cranston**. Ms. Melkonian, I would like your response to my general question, also, specifically, what do you think of what Deane Ross has suggested?

Ms. **Melkonian**. Well, specifically, as to that suggestion, it is one that I mentioned in my own testimony. In my view, one of the principal reasons why investors in low income housing was tax benefits, and therefore, their return is expressed to them in terms of tax savings. To be relieved of the liability that comes due at the time of a sale or transfer of a project, would be to, in effect, forgive a cost that was originally calculated into their return. Forgiveness of a tax liability, in effect, increases the return they originally expected. And as a result, it is a satisfactory reason for them to transfer the property for continued low income use.

So I definitely support that approach.

I think, in the broader context, we have to look at what does it take to maintain ownership of low income housing generally. Not just because of the prepayment problem, but also for projects that are struggling to meet physical and financial needs, as Mr. Grady pointed out and Mr. Heller pointed out. So I would look at all the tools that we have discussed: Changes in owner equity, use of capital loan funds directly from the Government, which is in H.R. 4, the use of the existing flexible subsidy program, the ability to use the new low income housing tax credit in connection with the existing stock, which requires modifications. All of these tools and others, taken on a case-by-case basis, will be useful.

Then, if we can determine that they will provide a fair and equitable return to the owner, in exchange for that, comes the requirement that low income use be continued, and I think that is what is whether the Congress' ability to extract as a quid pro quo.

Senator CRANSTON. Mr. Zigas.

PROPERTIES ARE IN IMMINENT DANGER OF SLIDING INTO DISREPAIR

Mr. ZIGAS. Well, Mr. Chairman, I would agree with all of these remarks. Our testimony also references the mechanisms Deane talked about, as well as a couple of others. I guess I would emphasize one thing. The objective we bring to this is certainly not to penalize owners, but to protect tenants, and I think that is clearly the same approach that Congress needs to take as well, and I would emphasize again that the vast majority of these properties are not in imminent danger of being sold. Many of them are in imminent danger of sliding into such disrepair that the Government is going to end up having to buy them.

I think the range of solutions you undertake has to be sensitive to that. But to focus for a moment at the end that really threatens displacement and homelessness for tenants at the high end, where the market value of these properties, in an unexpected way, I believe, has really accelerated and grown, I think the Government really needs to make the decision, and the Congress needs to emphasize it, that the maximization of profit in these properties, this windfall, was not one of the anticipated objectives of the Federal program. Congress has to fashion a series of both incentives to remain in occupancy and to remain in ownership, as well as disincentives to sell, so that a series of hurdles are created that owners really will be induced to interact with the incentives, and I think it would be mistaken to assume that simply offering an unlimited amount of incentive will be enough or would be advisable. That would be a very serious mistake.

I would also say that as you develop these solutions, I would again emphasize that the development of alternatives that pass this housing into a nonspeculative ownership model, I think, is very, very important, where it can be facilitated.

I know you don't want to and I know I don't want to come back in 15 years and have this same discussion about what we do about the projects that we figure out how to save this year and 15 years

The targeted housing stock for preservation should be all of the rental properties which today serve low and moderate income tenants. To relate that to the simplicity of a month's rent, we must focus on all rental housing with average rents at or below $400/month. We are thereby defining the housing needs of families with incomes in the area of $20,000/year. In some areas with higher median income, top rents may be higher and in others with lower median incomes top rents may be "low" $300/month. It is this rental housing, now able to physically and economically function in these rental ranges, that we must aim to preserve as affordable housing.

Most of this existing housing stock is owned by private investors who, as in the case of the HUD financed stock, acquired their ownership interest for a combination of tax incentives and longer term profit potential. The primary investment incentive for the billions invested by private owners in the HUD housing stock was clearly tax incentives. In most cases, the limitations placed on rents and the incomes of tenants effectively curtailed other economic benefits for twenty years from the date the property was built. With their tax benefit virtually exhausted by the length of time of ownership and by the 1986 tax law changes, owners must find economically sound methods for disposing of their investment. Two basic directions are available to all owners of low and moderate income housing. The most desirable economic direction for the private investor/owner is to "marketize" his property. In effect, he must move toward market rents to increase the income available for debt service and then either 1) refinance the property for more than the existing debt, or 2) sell the property to a buyer based on its distributable cash flow. to illustrate:

Assume an existing 221 D-3 property built in 1968:

Size:	200 Units
Debt:	$2,400,000 mortgage @ 3% interest
Debt Service:	$120,000/year Principal & Interest
Current Rents average	$375/mo or $4500/unit/year
Annual Rent Roll:	$900,000
Operating Expenses:	$755,000 (Approx. $3750/unit/year)
Net Dividend Distributable	$25,000/year

Assume the median income for the area in which the property is located is $25,000/year and the property could be marketed to families with incomes in the $25,000 - $30,000 range with modest physical upgrading at rents averaging $550/mo. or $6600/yr.

Rental Income:	$1,320,000
Expenses:	800,000
Available for Debt Service:	520,000

Option 1. Obtain a new mortgage for $5,000,000 @ 9%

Result: $2,600,000 cash to owners tax free

Option 2. Sell for $6,000,000 - based on net cash flow capitalized @ 8½%-9%.

Result: $3,600,000 cash to owners less tax due on sale.

The owner is clearly motivated to move in this direction in the course of which he would be compelled to displace many of the existing tenants. If their current rents are $375/mo. they would have to bear a 50% rent increase to remain under the new rents. The property would therefore be lost to the low income housing stock with all of the social displacement and upheaval inherent in evicting 200 families.

If the owners can not see a way to marketize the project, they will lose interest in the property and allow it to deteriorate. They would have no incentive to invest additional dollars for maintenance and physical upgrading and eventually the property will be lost as safe, adequate housing for low income tenants - a pattern we have seen all too often in the past.

To avoid these paths toward housing loss, we must develop alternative economic incentives for private owners to continue the properties as affordable housing or to transfer ownership of the property to new owners who are willing to provide the necessary resources to preserve the property as low and moderate income housing.

No one form of incentive alone will serve to meet all of the circumstances affecting the present housing stock. It is feasible however, to evolve a number of different, but related elements which individually and in combination begin the process of moving the existing affordable housing inventory into ownership entities whose objective is consistent with a national housing policy of preservation.

One of the most immediate threats to the housing stock are the circumstances surrounding the existing HUD inventory eligible for mortgage repayment in the next several years. The owners of many of these properties are at this point realizing very little of tangible economic value, however, they are faced with an overhanging liability if they sell the property to a new entity. As an example:

Assume the owners of the property described above acquired it in 1968 and invested a total of $500,000 of equity capital. During the period they have owned the property, they have probably taken almost $1,750,000 in tax deductions. In effect, they have recovered their initial $500,000 investment plus a profit to date. Now, however, if they sell the property, they will recognize a gain of approximately $1,250,000 plus any cash they receive. If they were to receive $500,000 in cash, they would pay a tax of approximately $550,000 or $50,000 more than they received. This overhanging liability is of continuing concern to these owners, first because it is doubtful they could find a buyer for the property as low income housing and they are uncertain as to their ability to marketize the property at a profit - the course they will try to pursue if no other alternative is available.

It might be pointed out at this time that the original legislation that created many of the incentives to attract private capital to build this housing envisioned this problem in 1968-69. That legislation created an exit program for some of the owners through Section 1039, whereby the owners could convey the property to a suitable non-profit or tenant group and reinvest the proceeds in another project, thereby allowing the basis in the old property to carry over to the new. Unfortunately, such reinvestment opportunities are virtually extinct so that option has become of questionable value.

Reestablishing this incentive is one method for preserving some of the low income housing stock that might otherwise be lost in the next five to seven years. A legislative proposal to redefine the original Section 1039 provision in the light of present day circumstances and needs is attached as Exhibit A. This provision, when enacted, will provide a positive incentive to existing owners of low income housing projects to opt for selling them to new entities committed to their maintenance as affordable housing.

From the point of view of many passive owners of HUD properties, the uncertainty of the overhanging tax liability is cause enough to accept an opportunity to sell the property to a new entity substantially below market value - often for the mere assumption of the debt. The very passive, uninvolved position of most investors will move them to accept a known result and the elimination of pending future liability versus the uncertainty of being able to marketize their property to sell at a profit.

It is reasonable to assume that over half of the HUD projects owned by limited partnerships would accept this option, particularly if the legislation carried a "sunset" provision of three years from date of enactment. Project owners who have five or more years remaining on their low income use restrictiions would be sorely pressed to act now versus waiting for five or more years to determine market conditions favorable for increasing rents and refinancing with relatively insignificant current tax benefits. A significant segment of the HUD stock would move to new owning entities of the type envisioned in the legislative propoals.

The pervasive question of the loss of revenue to the Treasury of this proposal is commented on in the attached exhibit. Current owners will not sell their properties, thereby incurring taxable income, unless the proceeds of sale are more than sufficient to cover their tax liabilities. The result of most of such sales would be to remove the housing from the low income inventory.

In fact, it could be suggested that the Treasury would gain revenue in the near term five year period since owners exercising the option of a revised Section 1039 sale would be foregoing additional passive losses which might be offsetting some of their passive income or accruing unused passive income to eventually offset the taxable effect of a future more profitable sale. This proposed legislation should clearly have no negative budget effect.

The proposed legislation recognizes at least three types of prospective qualified purchasers, each meeting certain prescribed circumstances which might prevail in the housing inventory as a whole. The overriding consideration must be a clear binding obligation to maintain the property for defined levels of low income use. A secondary qualifying element for affecting this type of transaction is movement in the direction of achieving ownership of the property by the tenants themselves. This objective was apparent as national housing policy in the 1969 legislation, but is even more valid today. If, through a new defined national housing policy, we can enact the necessary enabling legislation to bring about large scale ownership of housing by the tenants - with clear enforceable requirements for continued maintenance of the housing at affordable levels through any future ownership changes, we will have completed the logical social and economic cycle of placing control of the housing directly in the hands of those with the largest interest in its preservation.

However, the direct step to tenant ownership may not be realizable today. Existing tenants, for the most part, are not organized and trained to assume the burdens of ownership. Many of the properties are older and need capital infusions for maintenance and upgrading. Suitable financing mechanisms and enabling cooperative legislation, both local and national, need study and revision. By qualifying prospective buyers as private partnerships willing to provide the capital and management resources and/or community non-profit housing corporation with resources to meet property and tenant needs, a transitional condition is created whereby we can facilitate the movement of property from the ownership by existing investors who are not commited to preservation for low income use, to new ownership with a clear mandate and obligation to preserve the property as affordable housing. The new resources provided by these new, qualified owning entities will further assure property preservation and move in the direction of tenant control.

Certainly all owners will not elect to take advantage of a modified Section 1039 provision. This will be particularly true of owners of property very favorably located in high median income areas where the prospect of eliminating the low income tenant restrictions and bringing the properties to market rents or converting to condominiums or cooperatives is a very real and present prospect. It may not be possible to intercept all of these flights from the inventory, but we might achieve an effective compromise in at least many of these serious and volatile situations.

Returning to the prior example of the 200 unit 221 D-3 BMIR project - let us modify the assumptions somewhat. Instead of a community with a median income of $25,000, assume the median income is $30,000. The existing owners preceive that they might achieve rental levels as high as $600/mo. and still serve tenants at 80% of median income. However, under the existing HUD mortgage restrictions they are limited in rent increases they can effectuate, and, more important, in the cash distributions they might receive. At present their only option is to pay off the HUD mortgage and be free to pursue market rents which would eventually lose the property to the affordable inventory. From a practical point of view, however, the owners would have to find new financing at market rates of interest and go through a disruptive phase of tenant displacement to reach an income level to service the higher debt level.

A preservation comprise could be provided by new legislation. This proposed program would offer existing owners new HUD financing to replace the existing HUD debt on terms more costly than the existing mortgage, but less costly than new market rate financing. In effect, this is a revision of the existing HUD loan. Revising the existing HUD mortgage permits the Government to effectively share in some of the profit produced by liberalizing the provisions of the regulatory agreement. This proposal, in fact, increases income to the Government while preserving housing for low income use. In return for this favorable refinancing, the owners would agree to continue the property under a new regulatory agreement which would limit rentals to tenants at or below 80% of median income and require adequate protection for existing tenants. Owners opting for this refinancing would have no restriction on cash distributions or secondary financing.

Applying this program to the previous example:

1) HUD would refinance the existing $2,400,000 221 D-3 BMIR mortgage with a new $2,400,000 mortgage with interest at 7%.

2) The resulting debt service would increase by approximately $100,000 per year. This additional income to HUD would be placed in a reserve fund to meet specific subsidy assistance needs that may result from this program.

3) The owners could obtain secondary financing if they desired, consistent with the cash flow from the property.

4) The owners could raise the rents according to a preapproved schedule from an average of $375/mo. to as high as $600/mo. assuming all tenants were at 80% of median income. However, rent increases would have to be phased over a three year period, no tenants could be evicted during that period, and tenants would not pay more than 30% of their income in rent.

5) The owner would be further required to invest such sums as would be needed to upgrade the property physically to meet established HUD requirements.

The result to the owner at the end of a three year transition period might appear as follows:

Gross Rental Income	$1,400,000
Expenses	800,000
Debt Service	200,000
Net Cash to Owners	400,000

In effect, the owners have accepted a restrictive limitation on the properties' use and a mortgage more favorable than that available in the market in return for a program to protect existing tenants and retain the property as affordable to tenants at or below 80% of median income. The result is considerably less disruptive to the existing tenants and still serves important affordable housing needs in the community. More important, it will divert many owners of highly appreciated low income properties from their present plans for paying off the HUD loans and maximizing the market value of the property. This comprise financial alternative will preserve thousands of units for continued use as affordable housing.

The following data was drawn from three actual projects in California rapidly approaching the point when the mortgages can be repaid. The schedule shows the current rent being paid by the tenants and the increases that would be put into effect to bring the properties to 80% of current market rents. Despite rent increases of 30 - 80%, the properties will still serve families with incomes under 60% of median. If the owner has no other alternative, he will pay off the HUD mortgages and increase the rents dramatically higher than those shown.

PROJECT	Unit Size Bedrooms	Current Rents	Rent @ 80% of Market	Difference	Tenant Income Paying 30%	% of Median
VALLEJO Area Median Income $31,500	2	$ 317	$ 408	$ 91	$16,300	52%
BUENA VISTA Area Median Income $33,400	2	$ 255	$ 480	$ 225	$19,500	58%
EL RANCHO VERDE Area Median Income $39,200	2	$ 299	$ 520	$ 221	$21,000	54%

A preservation policy however, must also recognize the continued need for capital to maintain the physical integrity of existing housing. Many investors are satisfied to continue to retain ownership of low income properties, and would continue to provide additional capital to meet the needs created by the aging of their housing. Since the only benefit such owners originally sought was the tax benefit inherent in their original investment model, and with that benefit eliminated by the '86 Tax Act, there is little incentive for continued concern with the property and certainly no motivation to invest additional capital. We have created a scenario where investors with a desire to preserve the property consistent with national housing policy have no economically logical method for so doing.

Though entering the turbulent waters of revisiting the changes made in the '86 Tax Act will seem dangerous to some, it is totally illogical to let stand unquestioned a set of tax laws effecting low income housing which were enacted in the absence of a defined National Housing Policy. Tax policy affecting housing must evolve from a National Housing Policy mandated by Congress. Assuming that such a National Housing Policy is forthcoming, it is reasonable to reconsider the low income housing tax credit program and other provisions of the '86 Tax Act affecting low income housing.

The low income housing tax credit, as enacted, is a tool which can be modified to meet a newly evolved housing policy. As an example, assuming a new emphasis in preservation as the cornerstone of new housing policy, the tax credit can be revised to assist in preserving the existing housing stock. All revisions to the credit should follow the definition of housing policy since the tax credit represents a valuable committed resource to be used to assure an adequate supply of affordable housing.

However, it may not be premature to consider special circumstances effecting existing low income housing which can be helpful in meeting preservation objectives. The simplest of these are the circumstances facing existing owners prepared to continue their properties as low income housing for an extended period of time and who are willing to provide the needed capital to meet current physical needs. Clearly, giving existing owners some reasonable incentives to retain and maintain their properties is the simplest, most direct way of preserving properties. No transfer of ownership is required and the continuation of ownership assures the least disruptions to the property and the tenants.

Existing owners who agree to extend the use of the property as low income housing and commit additional capital for needed maintenance should be entitled to continued use of passive losses and/or tax credits on rehabilitation expenditures.

The HUD Flexible Subsidy program will also suffer unless changes are made in the tax credit program to encourage preservation by existing owners. In the past, owners contributed matching funds to the flex-subsidy loans from HUD as part of a defined program to assist needy projects. The motivation was tax benefits, and unless modifications are made to allow the use of tax credits or passive losses in connection with flex-subsidy loans, owner contributions will stop requiring larger outlays by HUD to preserve properties.

By providing combinations of tax credit and/or passive loss incentives to existing owners with appropriate HUD evaluation and administration, the objective of preservation can be attained in many instances, at minimal cost. *If* housing legislation carefully details the conditions for applying the tax incentives, existing owners will respond with the resources required to maintain affordable housing.

No one program will meet all of the requirements for preserving existing affordable rental housing. By understanding the circumstances governing various situations, the appropriate resources can be combined to achieve desirable housing objectives. As an example of combining programs available prior to the '86 Tax Act, consider the innovative but complex approach taken by a community non-profit housing corporation in Oregon to provide affordable housing.

1. The community non-profit identified existing units suitable for rehabilitations that were owned by private investors.

2. The owners were persuaded to sell their property utilizing the concept of a "bargain sale". By this form of sale, the former owners benefit by deducting the excess of the market value of the property over the realized selling price. Through this tax advantaged transaction the non-profit was able to acquire the property at a lower cost and the sellers benefited by tax deductions.

3. The non-profit arranged financing for the acquisition using tax free bonds induced by the local housing authority plus HODAG funds from the City.

4. The non-profit sold the property to a private investor partnership that provided the capital to do the necessary rehabilitation. The selling price included secondary financing taken back by the non-profit as seller, which increased the tax deductions through depreciation and accrued interest thereby increasing the investment capital available for rehabilitation. The incentives to the private investment capital were the tax benefits.

5. The secondary financing instrument taken back by the non-profit served, under its terms, to require the project to be retained for low income housing.

6. The private partnership entered into a lease arrangement with a cooperative formed by the tenants. This assured the tenants of a stable, predictable rental situation. At the end of ten years the cooperative has the option to purchase the property on favorable terms.

Through this sequence of transactions, and using several available financial tools, a small community non-profit housing group was able to preserve a portion of their cities' housing stock and put it in the economic reach and control of low income tenants. Many of the tools used are no longer valid, but some remain and others being proposed can more efficiently be substituted. For example, the "bargain sale" is more effectively replaced by the Section 1039 revision. The tax credit can substitute for the passive losses. Review and modifications of cooperative law could further facilitate tenant ownership.

The example merely illustrates that preservation of our nation's low income housing stock will require several different but complimentary elements that when joined at the community level will result in improving the supply and condition of affordable housing.

BY: A. BRUCE ROZET

CHAIRMAN OF THE BOARD
ASSOCIATED FINANCIAL CORPORATION

later have the same dilemma confronting us about, well, what happens now that those use restrictions ended. I think we need to take a leaf, a lesson from this long history and apply it.

Senator CRANSTON. We obviously have the need of protecting the tenants who can't afford housing at escalated prices. On the other hands, if we are going to have investors, we have to take reasonable account of their needs. How do we balance those two interests?

Mr. ZIGAS. Well, I think, again, for a large portion of the stock, the issue is not how to prevent people from selling, it is how to continue to induce them to make the housing available at all in the private sector. That is a whole different set of issues.

PROMISE OF FAIR AND EQUITABLE RETURN ON INVESTMENTS

On the back end, I think you have to take the position that Congress entered into these partnerships with owners and investors on a promise of a reasonable and equitable rate of return, which, from my experience working with the industry on the tax bill last year, was principally provided to investors at the time of investment as a promise of tax benefits that would flow to them by virtue of their participation in a partnership. I think owners and investors are entitled, certainly, to some equitable and fair return on their investment. I think it is up to Congress to establish what that really is and to exercise its own rights to ensure that no more than that is gained at the expense of low income tenants.

I really think that is where the issue cuts. We didn't come here to say, cut off owners or penalize them. We are not interested in that. We do think that the premise of a fair and equitable return is the one that deserves your attention, not the one of allowing owners whom lightning has struck, necessarly to maximize profit, because they happen to have found themselves in a position where they can.

Senator CRANSTON. Mr. Heller.

Mr. HELLER. I have three thoughts. First, I think it is very dangerous to generalize with respect to expectations of owners. I think that we will find upon investigation of projects of NHP, that owners entered into projects with very different expectations, many simply for tax reasons, others on what are highly risky projects, with the expectation of ultimate appreciation.

I agree with Barry, though, that there should be a range of options available to deal with the various situations that do arise.

Second, I think that it is important to emphasize that the real danger here may be less prepayment than the loss of subsidies, and because of lack of tax benefits, the possibility that investors will not be willing to put in the funds required to keep these projects up.

I personally am convinced, looking at 35,000 units of NHP, section 236 projects, that the level of interest rates at the time of prepayment is going to be the determinative factor as to whether prepayment is even an option to be considered.

The other circumstances at the time are going to be of great importance, as well.

Third, and relating specifically to Mr. Ross' proposal, it is probably appropriate to note that section 1039, when it was enacted in

1969, was viewed as a major exit device. To my knowledge, it has never been used. It was included at the time in the enactment of legislation for NHP, and I am afraid many of the characteristics of Mr. Ross' proposal suffer from the same disadvantages of the original section 1039. It may not go far enough.

We are considering at NHP a somewhat different proposal which would meet Mr. Zigas' objective of a continued nonspeculative use of the property.

We are establishing our own nonprofit entity, which would be independently owned and operated and monitored by an independent board of trustees, but affiliated with NHP.

We believe that for many projects, it would be quite appropriate for investors to contribute their properties either to our nonprofit or any other that might be established in return for forgiveness of the taxes that would come due, going one step further than that set forth in the proposal set forth by Mr. Ross.

The danger of any sale or donation to nonprofits, however, is that without continued funding sources, those nonprofits may not have the resources to provide the capital required for the upkeep of the properties.

I think, in fashioning legislation, it is very important for Congress to recognize that critical need for continuing funds for long-term low income use.

Senator CRANSTON. Thank you.

Deane, do you have comments on the comments on your comments. [Laughter.]

Mr. ROSS. Well, Senator Cranston, as many know in the industry, we have been dedicated to the preservation of the housing inventory for well over 10 years. This is not a new subject to us. We were very active in converting nonproft sponsored projects into limited partnerships back in 1976, when that program came into existence, for the purpose of marrying private sector capital to a local nonprofit organization, attempting to serve a particular constitutency in need.

I see the solution to the problem as the same partnership of Government, private sector, nonprofit sponsors. There is no one panacea, you know, for the problem. I think that there will be needed a number of tools in the grab bag of solutions. There is a broad spectrum of various owners in the Country and the needs of the projects vary greatly. Some are showing low cash flow. Some are great properties. Some have physical needs, are subject to heavy wear and tear, with constant ongoing needs.

We must address those issues.

I have covered a lot of things briefly in my statement, but just to show you some of the problems—one point, and certainly not the major defect by any means, in the tax act, is this conflict. We pass a tax bill which supposedly has tax credits, one for which purpose is to preserve the housing. We are hearing now, let's apply tax credits, and this will be one of the tools. But in the tax bill, it states that any secondary financing must be secured by the real estate, and yet HUD in its regulations and mortgage notes prohibit you from securing any secondary financing with the real estate, because it will cause an acceleration of the note. If that would happen, the mortgage could be accelerated by the lender, the restrictions are off, and it is foreclosed.

PROGRAMS WHICH ARE SELF-DEFEATING

So we have come up with programs which are self-defeating. And that causes the need to review the recently passed tax bill.

I also do not agree that we should delay an inordinate amount of time in studies. I think there should be prudent discussions, prudent studies, and I certainly welcome today's opportunity to participate in this one, but the programs which built the housing evolved and were improved over a number of years, and we went from a 221(d)(3) BMIR program to a 236, to a rent supplement to a Section 8, to a flexible subsidy, to a nonprofit conversion program, and all the way through with lots of modifications.

And so rather than sit back and say, wait till we have the perfect box wrapped up in a ribbon, I would say, let us move. The main first step is for Congress to enunciate its will that this is what we are going to do. We are not going to ignore this problem. We are going to focus on this problem, and we are going to take a step, and it may be 25 steps or 100 steps, but we are not going to let the homeless issue remain unaddressed and this housing problem ignored to contribute to the increasing homeless population.

Senator, in the L.A. Times on June 3—I don't know if you have seen this yet, but they predict a shortfall of low income housing of 19 million by the year 2003. Now we can debate here whether it is going to be 10 million or 15 million or 7 million, but these numbers are staggering and intolerable, and I don't think there is a person in this room who wants to sit back and say, let's do nothing and let this become reality.

So I think it is the team effort that will do the job.

Senator CRANSTON. Thank you very much.

I am going to have to try to wrap this up in about 5 minutes, because there is a roll call that has started. I don't want to go there and delay you and then come back.

Could I ask you to respond, not verbally now, but in writing, to a question I have about H.R. 4 and the legislative initiatives contained in it about HUD and Farmers Home prepayment programs. Your recommendations as to what you would like us to do in conference with the House, would be helpful.

Senator CRANSTON. Also, could one of you maybe just briefly respond on this, regarding the HUD and GNMA attempts to sell off about $9 million in mortgage assets to make deficit numbers look better, how do you react to Secretary Demery's comments, and could those sales make the problems even worse that we are now confronting?

Do you feel it could make it worse?

Mr. GRADY. Yes.

Senator CRANSTON. Yes.

Mr. GRADY. Definitely.

Senator CRANSTON. Any dissent from that? [Laughter.]

[No response.]

Senator CRANSTON. No dissent.

We then, presumably, should place restrictions on those sales. Would that be your view?

Mr. Zigas. We certainly believe so, yes, sir.

Senator Cranston. Ms. Melkonian suggested in her testimony that investors entered in these partnerships mainly for the promise of tax benefits obtained through rapid depreciation and other so-called passive losses.

She and others have also asserted that owners might receive windfall profits that were never anticipated.

I would like to ask you to comment in writing on that viewpoint.

I think that does complete our hearing for today.

I thank all of you very much for your very helpful testimony. A lot of interesting statistics, facts and opinions came to our attention, and I am grateful to all of you for that.

Thank you very much.

The Witnesses. Thank you.

Senator Cranston. The hearing now stands in recess.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Response to written questions and additional material for the record follow:]

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

June 29, 1987

Honorable Alan Cranston
Chairman, Subcommittee on
Housing and Urban Affairs
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, DC 20510

Dear Senator Cranston:

In response to your letter of June 16, 1987, I am attaching answers to questions you submitted to me.

I look forward to working with you on this important matter.

Sincerely yours,

Thomas T. Demery
Assistant Secretary for Housing--
Federal Housing Commissioner

Attachment

QUESTIONS FROM SENATOR CRANSTON

1. To date, no formal studies have been conducted on the "Opt-Out" component of the Housing Voucher Program.

A. Housing Vouchers are immediately provided to eligible tenants residing in projects whose owners choose to "Opt-Out" of their Section 8 contracts. These tenants are not required to be placed on the PHAs waiting list and therefore can immediately use Housing Vouchers to lease in place or move to another suitable rental unit.

B. The Housing Voucher Subsidy provides sufficient assistance to eligible tenants to lease suitable units with 30 percent of their adjusted income. However, the Housing Voucher Program enables tenants the flexibilty to spend more or less than 30 percent of their adjusted income on housing if they so choose.

C. Past experiences with tenant based programs demonstrated that 50 percent of families chose to stay in place. We expect a significantly higher percentage of families affected by owner "Opt-Outs" will choose to stay in place.

D. Combined Fiscal Years 1985, 1986, & 1987 - 1,471 housing vouchers were issued for use by families affected by owner opt-outs. All of these vouchers either have been or will be utilized by eligible families.

Questions for Thomas Demery from
Senator Cranston, Subcommittee on Housing and Urban Affairs

Q.2. In general, owners who participated in assisted programs were aware that the rate of return that they would receive during the first 20 years would not be as great as the cash flow profits realized by conventional mortgagors. To some extent, they anticipated that their properties would appreciate to recoup this loss.

The legislation creating the Section 221(d)(3) and Section 236 programs did not address prepayments. The issue was first addressed by HUD in the regulations. Owners who decided to participate in the subsidy programs took prepayment into consideration as well as the tax benefits and the fact that tax depreciation would run out at approximately the same time that they could prepay their mortgages without HUD approval.

When the owner reaches a stage where he/she exhausts all tax benefits, project rental income becomes phantom tax income. At this point the owner, based on the tax laws prior to 1986, could either refinance or use secondary financing to reestablish a depreciation base. In view of the 1986 Tax Act, however, they can no longer begin depreciation, thus causing them to consider other options.

One of the options available to the owner is to prepay and change the use of the property in order to increase the cash flow for profit, or to convert the property to condominium or cooperative use, thereby taking out their equity. If they decide to take out their equity by conversion then they will be facing capital gains tax on 100 percent of the profit instead of the 40 percent they would have had to face prior to the 1986 tax changes. Based on the foregoing, their future profits will be taxed at a heavier rate than they would have under the tax laws in place at the time they decided to participate in the program.

While I have not had the opportunity to discuss this item with industry representatives, I am sure the subject will be addressed in the studies conducted by either the Council of Managing Agents or the National Low Income Housing Preservation Commission.

I would also sound a note of caution with respect to assessing original investor motivation. These vary from investor to investor, and from deal to deal, depending upon that investor's expectation and method of calculating return, risk tolerance, liquidity requirements and other factors.

Q.3. There are very few projects that have reached the stage where they could prepay without HUD approval. We are in the early stages of negotiation with numerous owners to determine the types of inducements and their costs to the Department that would encourage owners to extend their lock-in agreements.

To date, the Washington/Dodd proposal is the only inducement plan that has been used to extend a lock-in. In general, this plan allows for secondary financing and subsequent repayment of equity, a change in equity base on which to apply the rate of return of 6 percent, and phased in rent increases of not more than 10 percent annually. Tenants, however, who are eligible for, but not receiving Section 8 are protected by a cap on rent increases based on the Annual Adjustment Factor, the Consumer Price Index, or 10 percent of existing rent. There is no tenant based subsidy in these projects so the cost to the Department will not increase. While the impact is on the tenants as rents increase for inflation and the costs of inducements, the ceilings will assure units remain affordable for the low- and moderate-income tenants the projects were meant to serve.

Q.4. a. The United States Housing Act of 1937 requires the Department to provide for adjustments in the maximum monthly rents for units covered by the Section 8 Housing Assistance Payments Contracts. Adjustments must reflect changes in the Fair Market Rents prevailing in particular market areas or be based on a reasonable formula. The Annual Adjustment Factors developed by HUD are based on a formula using rent and utility data from the Consumer Price Index and also the Bureau of the Census American Housing Surveys. Each Annual Adjustment Factor applies to a particular geographical area. Different Annual Adjustment Factors are provided for the four Census Regions, the States of Alaska and Hawaii, and 72 metropolitan areas. Application of a Factor to a prior rent for a unit many not result in material differences between the rents charged for assisted and comparable unassisted units as determined by the Secretary.

b. In certain cases the Annual Adjustment Factor established for a particular area may result in rents that are substantially lower than rents charged for comparable units not receiving assistance under the Section 8 program. If this occurs, a PHA or private owner may apply to the Field Office for consideration by HUD of a revised Adjustment Factor for the area.

c. The Adminstration's policy as evidenced by HUD's 1987 budget is to provide only vouchers, and not certificates.

Q.5. Regulatory Agreement forms previously in effect for Section 236 and 221(d)(3) programs are attached.

Q.6. Relative to the requested printout of information relating to several project-based subsidy programs, the information is attached, except for the following:

a. Item #5. This information is not now available. However, this Department has developed instructions for our Field Offices advising them to prepare a semi-annual report of the instances in which owners have voluntarily opted out of Section 8 contracts. The first report will be available in October 1987, and will contain the project name, number, type and length of contract, unexpired portion and reason of opt-out.

b. Item #9 and 10. This information is not now available. However our system is being updated and this information can be made available within 6 months.

c. Item #11. The owner's name is available but not the address or phone number.

Our current system does not have the ability to identify contracts with 5-year increments at the termination of which the owner can opt-out, prior to the expiration date of the total Section 8 contract.

Attachments

NOTE:
Attachments retained in Committee files.

United States
Department of
Agriculture

Farmers
Home
Administration

Washington
D.C.
20250

JUL 2 1987

Honorable Alan Cranston
Chairman, Subcommittee on Housing
and Urban Affairs
United States Senate
Hart Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are the answers to the questions regarding my testimony on prepayment of Farmers Home Administration Rural Rental Housing loans.

I appreciate the opportunity to further clarify the Agency's position on this matter. If I can be of further assistance, please let me know.

Sincerely,

Vance

VANCE L. CLARK
Administrator

Enclosure

Sorry For Delay! —

FmHA Farmers Home Administration is an Equal Opportunity Lender.
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, D.C. 20250

Answers for Senator Cranston from Vance Clark
June 23, 1987

1. Question: You testified before the Senate Subcommittee on Housing and Urban Affairs that prepayment is more acute in areas with large population growth and accelerating property values, in other words, tight rental markets. You then cited the fact that the President's 1988 Budget has set aside 1,200 vouchers for low-income tenants displaced or threatened with higher rents resulting from prepayments. If the moratorium on prepayments was to expire today, 8,000 Section 515 loans, which represents 166,000 units, would be eligible for prepayment. You are, therefore, proposing 1,200 vouchers for a potential universe of 166,000 units. You are also proposing a form of rental assistance -- vouchers -- which the evidence has shown is useless in tight rental markets, the very markets where prepayment will occur. How does the Administration explain these inherent conflicts in its position?

1. Answer: While it is true that 8,000 projects, with 160,000 units are eligible to prepay, the potential displacement of tenants does not approach this figure. Over 25 percent of our rural rental housing (RRH) loans were made to non-profit entities for which prepayment should not be a concern. Over 10 percent of all loans were made to full-profit entities for which rents have already been set at whatever rate the local market would allow, so prepayment would likely not raise these rents. In many areas of the country, limited profit borrowers appear to prepay loans because they wish to be relieved from FmHA regulation, not because of competing markets; for instance, of the 28 projects prepaid in Iowa in the three fiscal years preceding the moratorium, we are aware of no tenant displacement. Prepayment of projects with 100 percent Section 8 should cause no displacement; about 48,000 of our Section 515 units have Section 8 subsidy.

As you are aware, it is in States such as California, where property values are rapidly increasing, that prepayment of loans has caused a considerable burden for tenants. In many States, there are sufficient numbers of vacant units for displaced tenants to move to, while in California and other such growth areas, there are not. It is in these places that we feel the voucher program would be most effective. The regulation to be published provides that a borrower who prepays cannot refuse to allow current residents of the project to remain in the unit if they wish to remain and can pay the higher rent with or without subsidy. Housing vouchers would allow these tenants to remain in the unit which they had been occupying prior to prepayment.

In the three fiscal years prior to the moratorium, a total of 5,400 units were prepaid nationwide. In only 17 States, including California, were there more than 100 prepaid units for the entire State in the three-year period. In some of these 17 States (e.g. Iowa), prepayment caused no displacement. You should be aware that California's approximately 1,200 prepaid units during that three-year period was quite atypical. In fact, the next highest number of prepaid units in a State during that time was 335 in both Wisconsin and Texas; both States in which we are not aware of any displacement problems. Since not all prepayments would be occuring in a short period of time, we feel that 1200 vouchers should adequately cover potential displacements in the high rent States in FY 1988. However, if that is not sufficient, our total 1988 budget request is for 21,200 vouchers. Priority for those vouchers not specifically designated for displaced tenants would still go to displaced tenants. The vouchers themselves should serve to open up private sector units to low-income tenants.

2. Question: You stated that your proposed regulations "will solve the problem of displaced tenants efficiently, promptly and at reasonable cost." You then stated that your regulations "would require transferring rental assistance from prepaying projects to those Farmer Home projects able to absorb displaced tenants and give displaced tenants priority to continue receiving rental assistance." I would like to ask a series of questions about these proposed regulations:

a. What studies have you done to assure that there are sufficient undersubscribed Farmers Home projects to absorb displaced tenants?

b. Given that these projects are in rural areas and given that prepayments occur in tight rental markets, what is the likelihood that there will be vacancies for these tenants near their original homes?

2. Answer: We have not done extensive studies of the potential problems suggested by your questions. I believe, however, that we have sufficient data to justify our position. We recently made a telephone survey of vacancies in FmHA projects nationwide. Eighteen of our 46 State Offices have no prepayment requests on hand pending the end of the moratorium. In three other States, all requests to prepay are in projects with total Section 8 subsidy. In most remaining States, all prepayment requests are in counties in which there are substantial vacancies in the same FmHA District Office area. While this does not tell us the distance to these projects, it does indicate that displacement problems should not be extreme. For instance, in South Carolina, there are requests to prepay 15 projects with 342 units. However, there are 580 vacant units in the State. In every case, there are far more vacant units in the District in which the project wishing to prepay is

located, than there are units in the prepaying projects. In Indiana, three Districts have requests to prepay seven projects with 206 units, but in each of the three Districts affected there are more vacant units than will be needed to house displaced tenants.

There are, however, eight States where vacancies in at least one District would not cover displacement in that District. Three projects in one county in Georgia provide one such example, and of six projects with 246 units in the State of Washington, neither District affected has a sufficient number of vacant units to handle the potentially displaced tenants. It is in these situations that vouchers, rather than transfers of RA, could be used to fill the need.

3. Question: a. In your estimate, how far would a typical low-income tenant have to move to live in another Farmers Home Project? 25 miles? 50 miles? 100 miles? Many of the tenants in the Section 515 projects are elderly. What studies have you done to assess whether the burden you are proposing is reasonable for elderly people?

b. What regions would be most severely burdened by your solution--areas where the distance to another Farmers Home unit is greatest? What serious studies have you done on that?

c. Aren't the waiting lists in States like California so long that the notion of transferring rental assistance is a fiction, a myth?

3. Answer: When making a determination regarding displacement of tenants, our field offices look at projects in the same market area. Each office defines market area differently, based on local industry and residential and commuting patterns. Information from market studies used to prove project viability are utilized to help determine market area and, ideally, would be used to study the impact of displacement.

We know that about 1/3 of FmHA projects nationwide are designed for senior citizens and handicapped. We do not, however, know how many senior citizens are living in projects designed for families and do not, at this time, have information on the extent of displacement of seniors due to prepayment. We hope to begin compiling this kind of data in the near future.

During the period of moratorium, we received prepayment requests from 107 projects involving 28 FmHA State Offices. Twelve Districts in which these projects are located do not have sufficent vacancies to cover the displacements. These are in California, Colorado, Connecticut, Florida, Georgia, Michigan, Vermont and Washington. In some cases the discrepancy between units needed and those available are 1 unit. We realize this does not present the whole picture, since distances in a District can be quite large. However, we feel this is an indication that displacement is not a widespread problem. Where displaced tenants could not move to adequate housing within the same market area, we would wish to utilize housing vouchers.

It is interesting that in the State of California, which has generated much of the interest in prepayments, there is only one prepayment request pending. Our staff informs us that those projects which are eligible to prepay and which are located in areas in which prepayment is financially attractive, have already done so, and therefore the urgency is gone. Our information is that of the 1,200 prepaid units in California: 51 percent of the displaced families received Section 8 subsidies; 40 percent of the prepaid units were in areas where rent increases would not have been feasible; and 40 percent of those that were displaced in the high-income areas received rent subsidies. Our State Office estimates that approximately 450 families were adversely affected; that is, they lived in areas where it was financially feasible to raise rents, but did not receive Section 8 subsidies after displacement. We agree that this is far too high a number, but certainly not as serious a problem as looking at the total 1,200 units would indicate.

We are aware of the inadequacies of the statistical information the Agency possesses for answering the kinds of questions you ask. We have obtained some of the information in this letter through a telephone survey, and we are planning to make further statistical studies of FmHA projects which would allow detailed analysis to answer questions of the type you ask.

4. Question: Some analysts have argued that investors entered into the Section 515 Limited Dividend Partnerships in exchange for a reasonable return on their investment essentially through tax benefits. These people argue that allowing owners to prepay and evict their low-income tenants enables them to receive profits far in excess of what could reasonably have been anticipated at the beginning of the investment. What studies has Farmers Home completed to examine projects to discover the size of profits that were made? In specific, did Farmers Home in the years 1984 through 1986, when some 368 projects were prepaid nationwide, 35 in my State, analyze financial incentives, that may have been driving this sudden rush of prepayments? Who was benefitting and by how much? What would be necessary for FmHA to carry out such a study?

4. Answer: Tax benefits received by investors in the Section 515 program are not under the control of FmHA and so are not an area we have studied. We do not regulate the tax

incentives and the provisions of our regulations do not take these incentives into account. The borrower organizations would be the most likely source for this kind of information, if IRS cannot provide the data from an analysis of tax returns.

It should be kept in mind that tax incentives are one of the major reasons that the Secton 515 Program has been successful in terms of the numbers of units provided to eligible families. If a potential investor feels that the rules of the game may be changed after contracts are signed, the low-income housing program itself may be endangered because the potential investors will be wary of entering the program.

5. Question: a. What studies has Farmers Home conducted on the displacement resulting from prepayment? A recent study by the California Department of Housing and Community Development found that the prepayment of Farmers Home loans in my State ultimately displaced as many as 90 percent of the original low-income tenants. Has Farmers Home conducted its own displacement analysis? Does FmHA have the capacity to do so?

b. In light of the California study, what would you be willing to do to reconsider the effectiveness of your regulatory proposal and your reliance on 1,200 to 2,400 vouchers?

5. Answer: While Farmers Home Administration has data on the prepayment of loans, to date we have made no statistical studies of the impact of prepayment. We have relied on information received from organizations within the States, such as in California and Vermont, which have informed us of the problems. In States where there has been an impact, the FmHA State Offices were aware that there were substantial problems even though statistical data showing the exact extent of these problems was not available. As mentioned above, in most States, our State and District Offices are aware of no displacement problems. Therefore, we feel the problems have been localized.

Under our current procedure, FmHA employees rely on information provided by prepaying borrowers to document the extent of displacement. The revised procedure, soon to be published, will require complete documentation by the prepaying borrower, with review, analysis and corroboration of the information presented by the FmHA District Office, before a prepayment can be accepted. If the information presented by the borrower is found to be incorrect, the prepayment will be refused. The prepayment reports will then be forwarded to Washington for our review. We feel this will allow us to begin to collect much better information on the extent of displacement based on prepayment, which will help us to adjust policy in the future.

We still believe, however, that the 1,200 to 2,400 vouchers proposed will fill the need to allow tenants to remain in prepaid units.

Probably California's experience is typical of many parts of the country, however, in that the bulk of prepayments which were going to take place, already have. Pre-1979 projects remaining are primarily in areas where prepayment would not be economically feasible.

6. Question: HUD has conducted detailed studies to examine the universe of potential prepayments in Section 221(d)3 and Section 236 projects. They identified four categories: definitely will prepay, likely to prepay, unlikely to prepay, will not prepay. Has Farmers Home conducted a similar study for Section 515 projects? If so, what are the results?

6. Answer: A survey of intent to prepay is to be included in the survey of statistical information which FmHA hopes to conduct within the next few weeks. However, our telephone survey showed that 107 projects with 2,460 units requested prepayment during the moratorium. We feel this should accurately reflect the number of projects planning to prepay in the near future.

7. Question: Would you please explain the methodology you used to arrive at the numbers and dollar figures you mention on the botton of page 3 and the top of page 4 of your testimony in respect to H.R. 4 prepayment provisions?

7. Answer:

METHODOLOGY FOR OBTAINING COST ESTIMATE OF SEC.206 OF H.R.4

Costs for Sec.206 of H.R.4 originate from two basic sources: first Sec.502 (a)(3)(C)(i) and (iv) respectively, require FmHA to provide an "advance ... to cover any direct costs (other than the purchase price) incurred by the organization or agency in purchasing and assuming responsibility for the housing ...to enable the organization or agency to purchase the housing ..." Collectively, we refer to these two requirements as the "equity grant". The second source of costs associatied with this proposed legislation is Sec.502 (a)(3)(D) which requires the Secretary to provide financial assistance "to ensure that the monthly rent payment made by each low income family...does not exceed the maximum rent permitted under section 521 (a)(2)(A)."

1. COST OF EQUITY GRANT

The equity grant costs are divided into three components:

a. The "advance" will be for an amount to facilitate the transfer of the FmHA loan and sale of the property. We estimate this to be approximatly two percent of the original loan amount, which is the amount we currently require borrowers to have in reserve for unanticipated initial operating costs. This percentage takes into consideration the wide variance for these costs depending on the capabilities of the organization purchasing the project.

b. To facilitate the purchase of the project, FmHA is also required to provide a grant for the difference between the loan being assumed by the purchasing organization and the fair market value of the project. This grant will consist of an amount required to compensate for the equity increase since the origination of the loan, either from appreciation or from principal already paid. To estimate this amount, we determined the average amount of appreciation and principal paydown on a typical project funded prior to the restrictive-use requirements. This "typical" project consists of 20 units, with an initial $426,380 loan closed during FY 1978, with a 1 percent interest rate (reduced through the use of interest credit), and a fifty year term. The project's original value of $447,699 (loan amount plus the borrowers required 5 percent contribution) is assumed to have inflated 3.75 percent per year.

c. A summary of the "equity grant" costs are listed below:

FY OF GRANT	ADVANCE	APPRECIATION	PRINCIPAL PAID OFF	GRANT PER 20 UNITS
1988	$8,527	$134,309	$54,747	$197,583
1989	$8,527	$151,098	$61,903	$221,528
1990	$8,527	$167,887	$69,132	$245,546
1991	$8,527	$184,676	$76,433	$269,636
1992	$8,527	$201,465	$83,807	$293,799

FY OF GRANT	GRANT PER UNIT	GRANT PER 5000 UNITS
1988	$9,879	$49,395,750
1989	$11,076	$55,382,000
1990	$12,277	$61,386,500
1991	$13,481	$67,409,000
1992	$14,689	$73,449,750

2. COST OF FINANCIAL ASSISTANCE.

a. The cost of financial assistance is considered in terms of how we provide that type of assistance through existing FmHA programs; specifically, the FmHA rental assistance program. Currently, we obligate five years worth of subsidy at a time, at $11,047 per unit. For purposes of our calculations, we inflated this amount by 2 percent per year.

b. We looked at the cost of financial assistance from two perspectives. First, through five year funding which is the manner we typically receive rental assistance. However, those figures do not not illustrate the "life of the loan" commitment required by the language of the bill. So, we also portrayed the approximatly forty-year financial assistance commitment for tenants currently not receiving deep tenant subsidy (46 percent of tenants) and the thirty-five year commitment for those tenants who have deep subsidy now, but will have those funds depleted within the next five years (47 percent of tenants).

c. The costs associated with the "financial assistance" for 5,000 units subject to the provisions of Sec.206 each year are shown below:

FY OF OBLIGATION	5-YEAR COST PER UNIT	35-YEAR COST PER UNIT	40-YEAR COST PER UNIT
1988	$11,047	$115,284	$126,331
1989	$11,268	$117,589	$128,857
1990	$11,493	$119,941	$131,434
1991	$11,723	$122,340	$134,063
1992	$11,957	$124,787	$136,744

FY OF OBLIGATION	5-YEAR COST 2300 UNITS (46% OF 5000)	35-YEAR COST 2350 UNITS (47% OF 5000)	40-YEAR COST 2300 UNITS (46% OF 5000)
1988	$25,408,100	$270,917,400	$290,561,300
1989	$25,916,400	$276,334,150	$296,371,100
1990	$26,433,900	$281,861,350	$302,298,200
1991	$26,962,900	$287,499,000	$308,344,900
1992	$27,501,100	$293,249,450	$314,511,200
	$132,222,400	$1,409,861,350	$1,512,086,700

3. COMBINATION OF EQUITY GRANT AND FINANCIAL ASSISTANCE

a. The more reflective of the actual cost of this legislation is the following "life of the loan" cost as illustrated below for funding 5,000 units for 5 years (25,000 units assisted).

FY OF GRANT	35-YEAR COST 2350 UNITS	40-YEAR COST 2300 UNITS	EQUITY GRANT 5000 UNITS	TOTAL COST
1988	$270,917,400	$290,561,300	$49,395,750	$610,874,450

1989	$276,334,150	$296,371,100	$55,382,000	$628,087,250
1990	$281,861,350	$302,298,200	$61,386,500	$645,546,050
1991	$287,499,000	$308,344,900	$67,409,000	$663,252,900
1992	$293,249,450	$314,511,200	$73,449,750	$681,210,400
	$1,409,861,350	$1,512,086,700	$307,023,000	$3,228,971,050

b. The five-year cost of this legislation for the same 25,000 units without cosideration for the long term commitment is as follows:

FY OF GRANT	5-YEAR COST 2300 UNITS	EQUITY GRANT 5000 UNITS	TOTAL
1988	$25,408,100	$49,395,750	$74,803,850
1989	$25,916,400	$55,382,000	$81,298,400
1990	$26,433,900	$61,386,500	$87,820,400
1991	$26,962,900	$67,409,000	$94,371,900
1992	$27,501,100	$73,449,750	$100,950,850
	$132,222,400	$307,023,000	$439,245,400

National Corporation for Housing Partnerships

NHP

June 18, 1987

BY MESSENGER

The Honorable Alan Cranston
Chairman
Subcommittee on Housing and
Urban Affairs
United States Senate
Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Cranston:

I was very pleased to have the opportunity to appear before your Subcommittee on June 5. During the hearings you asked me and the other members of my panel to respond in writing to two questions:

Question 1: What is my recommendation with respect to the mortgage prepayment provisions contained in H.R. 4?

Response: I recommend that Section 261 of H.R. 4, "Prepayment of Mortgages," be stricken in its entirety.

NCHP believes there is a need for a careful and thoughtful study of the low-income housing preservation issue and that the enactment at this time of any legislation with respect to this issue would be premature. In our haste to rectify a present problem let us not create bad housing policy.

As I testified on June 5, NCHP is sponsoring and funding the organization and operation of the National Low Income Housing Preservation Commission in order to assist Congress in finding practical means to preserve the housing stock. The Commission, co-chaired by former House Banking Committee Chairman, Henry Reuss, and former HUD Secretary, Carla Hills, is already collecting data from which it will be able to draw meaningful conclusions not only with regard to the magnitude of the potential loss of the low-income housing stock but also with regard to what measures can be effectively used to avoid such loss.

1225 Eye Street, N.W.
Washington, D.C. 20005
202-347-6247

I believe your Subcommittee will be better able to formulate a sound approach to solving the preservation problem (including the prepayment issue) when it receives recommendations from the Commission and other interested parties this fall.

We, therefore, strongly recommend that the Housing and Community Development Act of 1987 not address the prepayment issue. However, when that issue is addressed, unwieldy procedures such as those currently in Section 261, although preferable to the right of first refusal language we opposed in the original H.R. 4, must be avoided.

Question 2: What is my position with respect to the imposition of a windfall profits tax on owners who convert low-income housing projects to market rate properties?

Response: NCHP is opposed to such a tax. It was suggested during the hearings that under no circumstances did owners of, and investors in, low-income housing ever consider the potential appreciation of assisted housing as a component of the economic benefits they would derive from their investment. Furthermore, it was argued, an assertion that they could consider appreciation is clearly contrary to the intent of the original legislation. Therefore, the argument concludes, a portion of the profit realized from the conversion of a property to market rate should be subject to a so-called "windfall profits tax." I take issue with those who so cavalierly make this argument.

First, it is incorrect to make a generalization with respect to the investment expectations of all owners and investors. Depending on the specifics of each project (that is, its location, market rent levels in its geographic area, and its general physical condition) owners and investors did make decisions to construct and invest in low-income housing based in many instances on both tax and profit considerations or in many other instances based solely on tax considerations. To arbitrarily declare twenty years later that legitimate expectations of appreciation will not be recognized--and furthermore, will be taxed--is, at the least inequitable.

Second, from a practical standpoint, it would be difficult, if not impossible, to equitably calculate such a tax. How could one establish the "base" profit from which windfall profits would be calculated? Would it be reasonable not to give credit to any appreciation? How do you value the economic risks involved in a project? How do you value the tax benefits projected to be received by taxpayers at the time of investment? How do you take into account the effects of the Tax Reform Act of 1986? Tax incentives bargained for by owners and investors were significantly reduced by the new tax law regardless of the date of investment, while at the same time owners' and investors' tax liability upon sale was significantly increased by eliminating the capital gains tax. Even those taxpayers receiving some relief from the passive loss provisions of the Act through the low-income housing transition rule will not receive the full tax benefits they anticipated receiving at the time they made their investment decisions. Clearly, where tax reform has arbitrarily taken away some of a taxpayer's expected tax benefits it would be just as arbitrary for investors to be deprived of economic benefits due to appreciation.

I hope you and your Subcommittee find these comments helpful. I look forward to the opportunity to discuss my views with you again on these and other issues related to our country's housing policy.

Sincerely yours,

J R Heller III

J. Roderick Heller, III
President and
Chief Executive Officer

cc: Don Campbell
Mary Dwyer-Pembroke
Grace Morgan

Testimony of

Richard B. Geltman
Staff Director
Committee on Economic Development and
Technological Innovation
NATIONAL GOVERNORS' ASSOCIATION

before the

Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
United States Senate

regarding

Prepayment of Federally Subsidized Mortgages for Low- and Moderate-Income Rental Housing

June 19, 1987

Mr. Chairman:

On behalf of the National Governors' Association, I express our appreciation for the opportunity to address the issues raised by owners of multi-family housing prepaying federally subsidized mortgages after the initial lock-in period has expired. An increasing number of owners are using this option. The National Governors' Association is deeply concerned that mortgage prepayments will result in the significant loss of units from the federally assisted housing stock for low- and moderate-income families.

The nation is faced with the potential loss of hundreds of thousands of federally assisted low-income housing units, often in the population centers where the need is greatest. At the same time, neither the unsubsidized private marketplace nor federal programs are constructing new low-income rental units or expanding the use of existing facilities for rental residential units to replace lost units or meet new needs. The federal government must give priority to low-income housing needs. It must provide incentives to stem the rising tide of prepayments, provide assistance to dislocated low-income residents, and subsidize new construction to replace lost units.

Over the last twenty-five years the federal government has subsidized the construction and occupation of low- and moderate-income rental housing developed, owned, and managed by the private sector. A number of the federal programs permit project owners to prepay their mortgages after twenty years or to leave the program after fifteen years. Between 1961 and 1973 the federal government subsidized thousands of rental units for lower income tenants through the Section 221(d)(3) below-market interest rate (BMIR) program and the Section 236 program, of the National Housing Act of 1934, as amended. Mortgages were subsidized for forty years, but the programs permitted the project owners to prepay those mortgages after the first twenty years. Later federal programs, such as the Section 8 existing housing loan management set-aside program, the Section 515 program, and the rent supplement program, were created that permitted owners to stop providing low-income housing after shorter periods of time.

Now some of the owners have owned property long enough to exercise their options to prepay or opt out. While the data do not clearly indicate how many owners either can prepay or will exercise the option, the potential national loss has been estimated at 300,000 to 400,000 low-income housing units over the next fifteen years. The greatest number of prepayments will be made in areas where state and local economies are most buoyant, rental markets are tightest, and low-income rental units are the least affordable. In those areas we expect a high level of prepayments, resulting in displacement of many low-income residents. These units probably will be converted to higher priced rental apartments, condominiums, or cooperatives; converted to commercial use; or razed and replaced with new, expensive residential or commercial facilities yielding a significantly higher rate of return.

NGA's concern stems from the lack of affordable housing alternatives for the displaced low-income residents. Under present federal budget allocations almost no new federally subsidized very low-, low-, or moderate-income rental housing is being constructed, and the use of Section 8 certificates and housing vouchers do not respond to low-income needs in areas where the supply of existing housing is tight. Moreover, the Tax Reform Act of 1986 has eliminated the tax incentives for private developers to construct or convert to low-income housing rental units. As a result, virtually no unsubsidized rental units are being financed with conventional or tax-exempt bond loans, by the private, for profit housing sector. While a number of states are using state appropriations, reserves, and bond financings to fill a small portion of the need for low-income housing, the states cannot replace the private sector and the federal government as the dominant providers of low-income housing.

The federal government needs to act. It must meet the challenges created by having given private owners the option to exit out of the federal subsidy programs. If it fails to act, the problem of homelessness will be greater, overcrowding of the remaining low-income residences will increase, and the remaining low-income units will likely deteriorate more rapidly.

NGA believes that while national housing policies should be designed to ensure adequate housing for the general population, particular attention must be given to the needs of low-income households. Priority must be given to programs that protect the physical and fiscal soundness of the nation's existing inventory of assisted low-income housing. NGA believes that the federal government must assure the continued viability and affordability of federally assisted housing and maintain its low-income housing programs at adequate levels.

The least expensive, least disruptive approach the federal government can take in dealing with mortgage prepayments is to induce the existing owners to remain in the federal programs. The federal government should explore a series of alternative incentives: altering existing contracts to induce owners to maintain rental units for low-income tenants at affordable rents; providing assistance for the projects' maintenance and repair needs to keep the low-income character of the projects and stave-off physical deterioration; and/or re-establishing tax incentives for the continued use of the facility for low-income housing. If the existing owners do not wish to maintain the low-income character of the projects, the federal government should provide financial assistance to state and local governments or non-profit organizations to purchase the property and continue utilizing it as low-income subsidized housing. Where the units are lost to the low-income, the federal government has a responsibility to subsidize the displaced tenants and assist in the construction of replacement units.

Because each project and locality is unique, it is important to maintain flexibility to shape individual "work-outs" with private owners or public parties. Indeed, it is important that the federal agencies work closely with state and local governments to resolve the individual situations.

From both a public policy and political point of view, the Department of Housing and Urban Development and the Farmers Home Administration must maintain at least their existing levels of budget authority for housing programs so that as prepayments are made, monies will continue to be made available to provide for the alternative solutions.

Mr. Chairman, thank you for your attention.

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STATEMENT OF
THE NATIONAL LEAGUE OF CITIES

on

PRESERVATION OF THE NATION'S LOW-INCOME HOUSING STOCK

before the

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES SENATE

June 5, 1987

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Statement of
The National League of Cities
on
Preservation of the Nation's Low-Income Housing Stock

Mr. Chairman and members of the committee, my name is Alan Beals. I am the Executive Director of the National League of Cities, the largest and oldest public interest group in the nation representing local governments.

I am grateful to you for holding these hearings. There is no question but that we are confronting a national housing crisis over the next decade - but a crisis which disproportionately affects families unable to afford homeownership and municipalities with greater levels of rental housing.

The crisis we face is not, however, either abrupt or unexpected. Rather we face the expiration or potential prepayment of programs enacted over the last two decades - but programs scheduled, deliberately, to expire over the next decade.

The problems we face at the municipal level have been instead exacerbated by a steady increase in the percentage of Americans who cannot afford homeownership, by a steady increase in poverty - especially in central cities and non-metropolitan areas, and by extraordinary cuts in federal assistance for low and moderate income housing. In effect, during the period when all of the nation's rental-housing assistance programs were expiring, federal actions accelerated, rather than mitigated the problems of homelessness and overcrowding.

Perhaps the most profound impact on the nation's low income housing stock has derived from the lead role in setting federal housing policy taken by the Treasury and the Congressional tax-writing committees. Whereas in 1980 nearly 4 out of every 5 dollars in federal housing subsidies were directed to low and moderate income housing needs through the Department of Housing and Urban Development, today the reverse is the case.

There is a significant difference, however. Officials at the Internal Revenue Service and the Treasury are the first to admit that their priority, responsibility, and experience is in setting tax and revenue - not federal housing - policy.

Thus while the total federal subsidies affecting the record federal deficit directed to housing have grown over the last 7 years, the percent of those subsidies directed to those in need or directed on a carefully considered federal housing policy has declined precipitously. It is ironic that federal housing subsidies for families that own a yacht which they wish to define as a second or vacation home for federal housing tax subsidy purposes has been such a significant priority to so many this year when homeless families have reached record levels.

Even the tax code itself has been shifting more and more against those most in need. Thus while the new tax simplification act is upheld for what it will mean for low income Americans - an average tax cut of $50 annually for families with incomes under $10,000, we project that the new law will increase rents from 18-30 percent - a dollar amount cost much more than offsetting the modest income tax gains.

While the new tax law has been portrayed by many as a significant step for fairness, in the area of federal housing policy no such claim can be made.

Moreover, with respect to your committee's concern about preservation of the nation's low income housing stock, the new law significantly reduces the capacity and ability of cities. The proposed termination of the mortgage revenue bond program, the severe volume limitations placed upon our ability to issue multifamily rental housing bonds, and the virtual elimination of authority to issue tax increment financing bonds markedly reduce the ability of states and local governments to help produce, rehabilitate, and retain low and moderate income housing.

This extraordinary shift in federal housing policy combined with the needs we testified about to you earlier this year in our research report, A Time to Build Up: A Survey of Cities about Housing Policy demonstrates we face both an immediate and a long term problem.

Over the long term, we are delighted at the leadership you have taken to begin to map out a comprehensive, new federal housing policy. We have begun such a process ourselves - coming at the request and initiative of our own officers. And we look forward to working with you.

In our view, one of the most critical tasks the committee faces in that process is creating a unified federal housing policy and budget. This means that all items in the budget affecting housing - tax, direct, or credit - should be put on the same table. We have not and do not concur with a budget process which scrutinizes only the portion of federal housing assistance under the jurisdiction of HUD and your committee, but which exempts the greater portion under the jurisdiction of the IRS and the Finance Committee.

Secondly, with less than 100,000 units likely from any housing bill before this Congress, the shortage of low income housing will continue and will continue to deteriorate.

This intensifies our priority to prevent the loss of existing inventory either through the sale of HUD assisted mortgages or the prepayment and conversion thereof.

In that regard, we want to make it clear that we do not favor abrogating the rights of those owners who in good faith negotiated with the federal government to provide low-income rental units. A contract is a contract. The federal government should approach these owners with carrots in hand; some of these federally assisted projects are in good locations -- not real estate markets.

Among the incentives both federal and local governments can offer is continuation of existing subsidies to keep these units affordable to low income tenants.

Our research report indicates that when we asked what the most cost-effective Federal housing programs are, CDBG and Section 8 Existing Certificates received by far the most votes.

Policy options that need further consideration include:

* The reauthorization legislation should include careful standards in order for HUD to approve a prepayment request. It is our understanding that some regional and area directors of the Department understand that they have no flexibility in this regard and must automatically approve any such request. We believe that to be inconsistent with the law and the intent of Congress.

* We would hope that as part of any banking reform efforts agreed to as part of the recapitalization of FSLIC, the Congress would include provisions strengthening the Community Reinvestment Act to require investment of a portion of any FSLIC insured bank's capital for low and moderate income housing.

* We would hope that the committee would make a point of including some provisions in any final welfare reform legislation recognizing the fundamental role of shelter as the foundation upon which any escape from welfare dependence must be erected.

* We would hope the committee would consider creating a Housing Trust Fund to provide replacement units for those projected to be lost due to either prepayment or expiring Section 8 contracts, and that such a trust fund would include an incentive for states or municipalities which have created their own trust funds for low and moderate income housing.

These are some of the options we will be exploring with our membership in the coming months. They are options which we feel are consistent with federal budget constraints, but recognize the time bomb coming our way unless some response for this growing crisis is reached.

Once again, I am grateful for the opportunity to submit comments reflecting the views of public elected officials from our 15,000 direct and indirect member cities and towns. We appreciate your recognition and concern about this issue, and we look forward to working with you on constructive remedies.

NAHRO National Association of Housing and Redevelopment Officials
1320 Eighteenth Street, Northwest, Washington, D.C. 20036 (202) 333-2020

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOUSING AND REDEVELOPMENT OFFICIALS

BEFORE THE

SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE UNITED STATES SENATE

HEARING ON

"DECLINE IN THE SUPPLY OF RENTAL HOUSING"

June 5, 1987

Melvin J. Adams, President, **Helen L. Sause**, Senior Vice President, **Howard T. Byrd**, Vice President—Commissioners, **Joseph E. Gray, Jr.**, Vice President—Community Revitalization and Development, **John Simon**, Vice President—Housing, **Joan Smith**, Vice President—Member Services, **Wayland R. Smith**, Vice President—Professional Development, **Robert W. Maffin**, Executive Director

The National Association of Housing and Redevelopment Officials is pleased to have the opportunity to submit a statement to the Subcommittee on Housing and Urban Affairs on "The Decline in the Supply of Rental Housing." NAHRO represents over 2300 agencies across the country that are involved in housing and community development programs. Our members are involved, in one form or another, with most of the federally assisted housing programs and with a variety of state and local programs as well. For over 50 years NAHRO has fought for the provision of affordable housing for low and moderate income persons. Thus the issue before this committee is one on which we are pleased to offer our views.

It is important to put this issue in the perspective of some overall forces affecting housing for low income families in this country. In a report we issued in 1985, NAHRO identified a coming rental housing crisis for low income families by the end of this decade. 1/ Absent a reversal of existing federal policies a crisis in affordable and decent housing for low income families is inevitable. Without exaggeration , we can say that the problems now evident are only the tip of the iceberg. The direction of current demographics, combined with current housing policies, can only produce a critical shortfall of affordable housing in the next decade.

Most frequently discussed of these issues is the loss of direct federal subsidies to produce housing for low and moderate income families. The budget of the Department of Housing and Urban Development for assisted housing has been cut by 74 percent since 1980. Production or rehabilitation of actual units for low and moderate income families has practically ceased, declining from 129,490 units to 16,500 units in the same period.

The Tax Reform Act of 1986 removed most federal tax incentives to produce housing for low and moderate income housing. The elimination of favorable tax treatment, and the loss of substantial authority for housing bonds, has all but dried up tax supported production of low income units.

Lower rent units from the private, unassisted housing stock have been disappearing at an alarming rate--either by falling into disrepair, by conversion to condomium or other ownership housing, or by rehabilitation and upgrading to higher rent units. Over two million units affordable to low income households were lost from the housing stock between 1974 and 1983.

At the same time the needs have been increasing. During the same period that the affordable stock decreased, the number of renter households earning under $10,000 increased by three million. Half of all rental households (as of 1983) pay excessive rents or live in physically inadequate structures.The situation is worse for low income renters, with fully 80 percent of these households either paying excessive rents or living in inadequate structures.

Public housing remains a major resource, but one that is also under stress. Because of past neglect from inadequate funding, there is a backlog of modernization needs estimated by HUD at over $20 billion. Current policies on tenant incomes and rents, coupled with rising costs and declining federal subsidies, make it ever harder for public housing authorities to maintain decent units. And despite a national backlog of households on waiting lists in excess of 800,000 no significant new construction is being funded.

This series of problems is not unrelated and serves to place the current issue of prepayments in perspective. The supply of housing funded under Section 236, Section 221(d)(3), Rent Supplement, and Farmers Home Administration Section 515 represent a major national resource which cannot easily be replaced. Especially in the current environment, we simply cannot afford to lose units that are affordable to low income families.

In a different environment the original tenets of the programs might be viable--that the units provide affordable housing for a 20 year period and then convert to market rate units at the owners' option. The situation is radically different than when the programs were formulated and a different response is called for.

NAHRO understands those who argue that the contractual rights of owners should not be abrogated, and we are not without some sympathy for that approach. We do believe, however, that public policy should mandate that every feasible alternative be pursued before units are allowed to convert to market rate.

In the short run, NAHRO supports an approach similar to that outlined in the House bill, H.R. 4. While not presenting a complete solution, the bill does provide notice of prepayment, establishes as national policy to encourage units to remain in the affordable inventory, and recognizes the potential role of nonprofit and public agencies in preserving these units. The bill provides a limited approach while a more comprehensive solution can be developed. We encourage the Senate to adopt similar provisions.

A more comprehensive approach is needed, however. NAHRO suggests than any permanent solution should encompass the following criteria.

The needs of existing tenants for decent and affordable housing should continue to be addressed. In units that eventually prepay, this means the provision of rental assistance so that comparable, affordable housing can be found. In tight housing markets Section 8 vouchers and certificates, as currently structured, may not be a workable solution. Special provisions may be needed to insure that the units they are in remain affordable using Section 8 assistance or that other units can be found.

Owners should be encouraged to maintain the low income nature of the units by the provision of added financial incentives. A range of potential incentives have been noted by other commentors. NAHRO would only add at this point that tax as well as direct federal subsidies should be considered as possible alternatives.

Serious consideration should be given to a priority for purchase, perhaps including a right of first refusal, by entities that agree to maintain the units as low income, whether these are nonprofit, for profit, public investors, or organizations of tenants. Such a program would necessarily have to include some federal assistance, perhaps in tandem with state or local assistance, to aid in financing the purchase. We recognize that a first refusal concept could be interpreted as infringing upon rights of owners to dispose of the property for gain to benefit investors. Such a program could be drafted so that the reasonable rights of current owners are respected. This approach could also help insure that the projects would remain in the low income inventory for the life of the unit.

Finally, we suggest that adequate attention must also be paid to providing financial assistance to projects in need of rehabilitation.

With potentially 1.8 million low and moderate income units at least potentially at risk (according to GAO estimates, and including Section 8 New Construction/Substantial Rehabilitation), federal action to preserve these units is essential. We urge the committee, however, to also consider the need to focus on the range of problems confronting units affordable to low income and the need to insure that all these remain, to the extent feasible, remain within the low income stock. Such a program should include the continuation and expansion of funding to rehabilitate the private stock of units affordable to low income. And we must insure that adequate funds are provided to maintain the 1.3 million low income rental units in the public housing stock, by providing adequate modernization funds and adequate funds to keep projects operating soundly and in good repair. Unless these issues are also addressed, a solution to the problems presented by prepayment will do little to prevent the coming crisis in affordable and decent housing for low income families.

The ultimate solution, of course, must involve a coordinated national housing policy that recommits this nation to the goal of a decent home and a suitable living environment for every American family. NAHRO commends the Chairman and the rest of the committee for the intent to propose such a policy and we look forward to working with you in that endeavor.

1/ "Rental Housing in the 1980's: Prospects for Low Income Households". NAHRO: August, 1985.

Council For Rural
Housing And Development

STATEMENT FOR THE RECORD OF THOMAS R. RUNQUIST, PRESIDENT
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT
BEFORE THE HOUSING AND URBAN AFFAIRS SUBCOMMITTEE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

June 5, 1987

Mr. Chairman and members of the Subcommittee, my name is Thomas R. Runquist, I am Chairman of First Centrum Corporation of East Lansing, Michigan and President of the Council for Rural Housing and Development. I am submitting this statement for the record on behalf of CRHD on the crucial issue of prepayment of loans on Section 515 federally assisted projects after the twenty year lock-in period.

CRHD is a national association of more than 160 member organizations and eleven state associations actively involved in the construction and management of rental housing through the Farmers Home Administration's Section 515 program.

This Committee will be considering the prepayment issue in the context of all of the assisted housing programs. Because our group is exclusively dedicated to the furtherance of the Section 515 program, we will confine our testimony to a pressing Section 515 issue - the right of owners of Section 515 projects with contracts entered into before December 21, 1979 to prepay their obligations. This is a unique problem, as pre-December 21, 1979 FmHA projects are virtually the only ones where owners are free to prepay at this time, subject to a moratorium contained in the FY87 appropriations bill, expiring on June 30, 1987, denying the utilization of any FmHA funds to accept such prepayments. Having said that, let us emphasize that many of our members also own projects under the various HUD programs and our strong stress on the fidelity owed by the United States government to its contractual commitments is equally applicable to all federally assisted projects.

Background of Prepayment Provision

As this Committee is well aware, in Section 503 (b) of the Housing and Community Development Amendments of 1979, the Congress amended Section 502 (c) of the Housing Act of 1949 to prohibit the Secretary from accepting prepayments for loans made before or after enactment of that amendment for a 20 year period.

Immediately on passing the legislation, many members of Congress realized that it was extremely unfair to remove retroactively the right of owners to prepay, when their note and

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mortgage contains no such restrictions. Indeed, the legislation up to that point required such prepayment if the owner was financially able to do so.

Let us emphasize that this concern for sanctity of contract is a real one. What separates our form of government from a totalitarian society is the fact that our government and its officials are bound by legal obligations and restraints. It is a basic tenet of our society that worthy ends do not justify unconstitutional or illegal means. Equally basic is that a person entering into a contractual obligation with the government has the right to expect that the government will honor its obligations just as the government is entitled to the same expectation from the private contracting party. Sanctity of contract is just that.

Reacting to this fundamental fairness issue, the Congress took the very unusual step of repealing, in less than one year of enactment, the retroactive restriction on the owner's right to prepay on pre-1979 contracts.

In addition to the basic concern about adopting retroactive legislation, viewed as repugnant to all legislative bodies, was the even greater concern of the effect that the retroactive restriction would have on private sector participation in housing programs. For the last twenty years, our national housing policy has been premised in large measure on the participation of the private sector in federally assisted housing programs. To ensure such participation, it is essential that the government operate in good faith. Retroactively applying restrictions on prepayment which were not there when an owner entered the agreement is no way to secure such good faith. Thus, a motivating factor for the 1980 Congressional action was to assure the private development community that the government would honor its word, and it would thus be prudent to participate in programs such as Section 515.

The basic unfairness to the owner of retroactive legislation is very well illustrated in the case of Section 515 projects. Many owners who entered the program before 1976 realized that their tax benefits would run out in about 10-12 years and that the projects would be unprofitable to hold thereafter. However, this fact was mitigated by the owner's right to prepay on the Section 515 mortgage, and to substitute conventional financing and thn operate as a market rate project. The law in effect at that time not only permitted the owner to do so, but mandated such action if financially feasible. Accordingly, it is extremely unfair to now say to an owner that the government has changed the deal, and that the right to prepay has disappeared.

Meeting Tenant Concerns

Up to this point, we have stressed the concern that the government keep faith with project owners. However, we want to emphasize as strongly as possible that since its inception, CRHD has recognized the needs and concerns of our tenants, both for the individual project tenants, and the national organizations that represent them. From the beginning, we have worked extremely closely with the Housing Assistance Council and National Rural Housing Coalition to ensure the future of the Section 515 program.

I would like to first note that at this point we do not know the extent of the problem we have concerning prepayment on pre-December 21, 1979 loans. Generally, interest in this problem has been engendered by several incidents in California of prepayments and alleged tenant displacement. To our knowledge, this is not a widespread phenomenon. Indeed, in many rural counties, there is no market for the units absent the subsidy of the Section 515 loan, and accordingly prepayment poses no significant problem. Further, the privately owned pre-1979 projects are a finite universe of less than one third of the existing Section 515 stock.

Although we are not sure of the extent of the problem, we believe that it must be dealt with in a positive fashion. Any low income family left without a home is one family too many. To mitigate the effects of any prepayment, we recommend the following actions.

1. Any tenant displaced as result of prepayment on a Section 515 project should be automatically entitled to a Section 8 certificate or a voucher utilizable in any apartment in the area. In order to assure that this is done, we recommend that this year's housing bill include a direction to HUD to so earmark certificates or vouchers.

In this regard, it should be noted that rural areas are entitled to at least 20% of the Section 8 certificates and vouchers. Accordingly, using certificates or vouchers to meet the needs of tenants displaced because of prepayment would not cut into the utilization of voucher funds in urban areas. It is expected that in FY87 there will be at least 60,000 free standing vouchers or certificates and 12,000 would be utilizable in rural areas. As there have only been prepayment on 5,377 units in the last three years, there should be ample rural vouchers to meet the needs of those displaced.

2. If the displacement occurs in areas where there is a shortage of rental housing, then the Farmers Home Administration should be directed to make a priority allocation for new projects to the area in which the prepayment occurs. Such priority allocation would meet the supply problem to ensure that adequate stock is available in the area for the low income family.

3. The Farmers Home Administration has the authority to make loans for condominium units as well as detached single family homes under Section 502. If a project is converted from Section 515 to condominiums, then FmHA should implement its

authority to make Section 502 condominium loans so that the new low income condominium owners can have the benefit of as low as a 1% loan. Our understanding is that ample Section 502 funds would be available for this purpose.

4. The above suggestions are directed to mitigating the consequences of prepayment. The best solution would be to eliminate the cause of prepayment and the lack of profitability of maintaining the projects under Section 515. At this time, Farmers Home limits annual cash returns to owners to a maximum of 8% on the amount of the owner's original equity, which is considered to be 5% of the total project value. For example, on a project with a total development cost of $500,000 in 1976, the owner's return is limited to 8% of the original equity of $25,000, or $2,000 per year. That $2,000 has remained constant for the 10 year period. Unfortunately, inflation has cut its value to about one third of what it was worth in 1976. At the very least, FmHA should permit an 8% return on today's value of the original equity, so that the owner's return in real dollars remains the same. In other words, the equity should be indexed for inflation. As the Housing Act of 1949 does not prescribe a specific rate of return for a limited dividend sponsor, we believe that the Farmers Home Administration has the ability to permit the greater return at this time. Bear in mind that when the tax incentives have run out, usually after the tenth year - the only financial incentive is the cash return to the owner. Farmers Home should do as much as possible to make that return fair.

5. As part of the Tax Reform Act of 1986, Congress enacted a new tax credit that encourages owners to retain their property and to rehabilitate it. In such case, owners holding their property for more than 10 years will receive a 4% tax credit on the rehabilitation expenses if the loan is federally subsidized, and a 9% tax credit on the rehabilitation expenses if it is a conventional loan. The Farmers Home Administration has a subsequent loan program that can be utilized for rehabilitation of Section 515 projects. We believe that proper use of this subsequent loan program, along with the 4% tax credit, could provide a very attractive package to owners to keep their property under Section 515 and to perform such rehabilitation as is necessary.

The H.R. 4 Buy-Out

Although we had suggested these alternatives in testimony to the House Housing Subcommittee last September, they chose to take a different approach in Section 306 of H.R. 4. In essence, if the owner of a pre-December 21, 1979 project elects to exercise the right of prepayment, he or she would have to offer the project for sale to a non-profit organization at the project's fair market value. Funding is provided in the House bill for purchase of 5,000 units per year.

When it became apparent that the House Banking, Finance and Urban Affairs Committee deemed the buy-out the best approach to follow, CRHD worked very closely with the Committee and its staff. We sought to assure that the buy-out provisions would provide the owner effectively the same financial benefits as if prepayment were made and also to assure that if the owner chose to prepay and retain Section 515 eligible occupants in the project, the owner should have that option. We are pleased to report that Section 306 as reported by the House Banking, Finance and Urban Affairs Committe does contain many of the protections that we sought, such as:

- a provision that the final price be determined by an independent appraiser, if appraisers appointed by FmHA and the owner cannot agree on a price;

- provisions permitting the owner to prepay:

    if the owner agrees to keep the project in Section 515 occupancy for 20 years from the date of the loan, or

    if equivalent housing at similar rents is available to Section 515 tenants within 25 miles of the project, or

    if within one year of the owner's announced intent to prepay, funding is not available for a non-profit to purchase the project; or

    if a qualified non-profit is not available to purchase the project within 90 days of the owner's offer to prepay.

We believe these are most salutary provisions which we hope would be retained in conference if the Senate chooses to utilize the buy-out approach.

We were very disappointed that the House committee rejected one of our key suggestions - that limited profit entities be eligible to purchase a project from an owner seeking the right to prepay, assuming there is no relationship between the buying and selling limited profit entity. We believe that private motivated sponsors have made real contributions to every phase of the Section 515 program and we see no justification for them being shut out of the buy-out opportunity. Of course, limited profit purchasers would be subject to the same use restriction for the same length of time as would non-profit purchasers under our proposal.

Let us again emphasize that the best approach would be our basic proposal of utilization of Section 515 certificates combined with incentives to keep the owner in the project. Our discussion of the buy-out becomes relevant only if the conferees choose to pursue that approach instead of our preferred solution.

We look forward to working with your committee and its staff to emerge from the conference with a resolution of the prepayment issue that respects the contract rights of the owner while assuring that no present Section 515 tenant goes without decent housing in the area in which he or she lives.

HAC

HAROLD O. WILSON
Executive Director

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Testimony of

Harold O. Wilson, Executive Director

Housing Assistance Council

Before the Subcommittee on

Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs

United States Senate

June 5, 1987

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Mr. Chairman and distinguished members of this subcommittee, I am Harold O. Wilson, Executive Director of the Housing Assistance Council (HAC). HAC is a national nonprofit organization concerned exclusively with housing problems of the rural poor. We are very pleased to be invited to present our views on the housing situation in rural areas and proposed legislation to assist the rural poor.

I wish to express HAC's strong support for legislation addressing the problems of prepayment FmHA Section 515 loans. We urge this subcommittee to act on a bill that will adequately protect the housing needs of the rural poor.

Prepayment of Section 515 Loans

The Housing Assistance Council is deeply concerned about the plight of low and very low-income tenants who may be displaced or subjected to increased rents by the prepayment of FmHA Section 515 loans. This growing problem will have increased impact upon low-income rural tenants in the near future. We greatly appreciate the efforts of this subcommittee to address this problem. The moratorium enacted last year greatly helped, but we must have a long-term solution to this matter.

HAC has been closely reviewing this problem, and has determined the following:

1) prepayment is causing displacement of low-income rural tenants;

2) housing units subsidized by the federal government are being irrevocably lost without replacement due to federal budget reductions;

3) the steady loss of low-income housing stock due to prepayment will create enormous and unnecessary fiscal expense in the future as units are replaced;

4) the recognized and substantiated low-income rural housing need remains at unacceptably high levels.

HAC has developed in-depth rural housing need studies and has used information from the Congressional Research Service (CRS), the General Accounting Office (GAO), and Farmers Home Administration (FmHA) to demonstrate the unfortunate effects of prepayment on FmHA rental units. We strongly urge adoption of legislative remedies to provide a long-term solution.

Central to this issue is the preservation of units specifically built for low-income rural tenants. Allowing prepayment of 515 units with no protection for low-income residents is a mistake which must be rectified because of the burden on low-income families and the expense it causes the federal government. The current moratorium has provided some welcome relief, but unfortunately it expires at the end of this fiscal year.

It was my privilege in 1979 to testify in support of limitations on prepayment. HAC supported legislation limiting prepayment for the entire 50-year mortgage term. Ultimately, the two Houses of Congress conferred and agreed upon 20-year restrictions, with somewhat lesser conditions for loans made prior to 1979. Many of us remember the 1980 legislation repealing the retroactive provisions. Proponents of repeal claimed displacement was an isolated factor, and that growth of federally subsidized units would assure replacement housing for low-income tenants.

Unfortunately, history has proved otherwise. Displacement by prepayment is increasing at a pace threatening stability for rural families. Federal housing programs have not grown. In the face of growing need, they have been reduced dramatically.

A. Displacement

The California Study. After 1980, little attention was paid to the rural aspect of prepayment except by legal services attorneys and the National Housing Law Project. A 1985 California Department of Housing and Community Development (DHCD) study on federally-assisted rental conversions identified 16 California Section 515 projects. They totaled 453 prepaid units during 1984 and 1985, and another 394 units in 7 projects pending as of November 15, 1985. Based on the very limited availability of alternative affordable housing, the study estimated that 90 percent of these tenants were or will be displaced. Seventeen (17) percent of all California Section 515-assisted units have been prepaid since 1977. Attached is statistical information on California prepayments during fiscal years 1984-1986.

Also attached are tables illustrating the existing and potential impact of unrestrained prepayment. A General Accounting Office report noted the enormity and gravity of a policy permitting poor families, mostly elderly, to be displaced from their homes. The current policy represents nothing more than officially condoned evictions of low-income rural Americans. The following data illustrates the problem:

- GAO estimates that by the year 2005 up to 275,169 Section 515 units could be prepaid.
- 365 projects with 5,373 units were prepaid during fiscal years 1984, 1985, and 1986.
- An additional 45 loans, for which unit data is incomplete, were pending as of August, 1986.

- Of 366,406 units financed from 1963 through 1985, an estimated 191,794 or 52.3 percent are eligible for unrestricted prepayment. 159,534 units, or 44.7% of 357,318 units in the current housing portfolio, were approved prior to December 21, 1979.

- 1,262 loans, or 11.3 percent of those made prior to fiscal year 1980 (those essentially eligible for unrestricted prepayment) have already been prepaid.

- 61.5 percent of all closed and operational Section 515 units, as of August 8, 1986 have limited-profit ownership. These owners are most likely to seek prepayment, compared to nonprofit, public or market rate borrowers.

One California FmHA District Office reports three prepaid projects with tenants in 94 of 106 units (88.7%) dependent on FmHA Rental Assistance. These tenants, unable to afford FmHA basic rents of $185-$205 per month, are facing rents ranging from $300 to $400 per month. The FmHA report on vacant units availability concluded there were "none that displaced tenants can afford". In another California project, an 83 year old woman with a fixed income of only $455 per month has been paying 25 percent of income for rent, including utilities. Her rent after prepayment is now $375, leaving her a total of $80.00 per month for food, clothing and related items. To remain in that project she must pay 82.4 percent of her income for rent. Obviously that is impossible. Speculation on her future is not encouraging.

Mr. Chairman, this problem is not limited to California, where 71 percent of the tenants in 1984-1986 prepaid projects received rental assistance. Vermont Legal Aid, Inc. reported several projects lost to prepayment. They identified one prepaid project where 90 of 112 families were displaced in 1985. The preliminary FmHA statistical report indicates displacement is occurring in several states, and the tendency for prepayment is mounting. FmHA is currently gathering data, and we will submit additional reports to the subcommittee as information becomes available.

B. Replacement Housing

Continued Housing Need. A Congressional Research Service (CRS) report (No. 86-517S, Morton J. Schussheim) in January, 1986 illustrates rural housing need. CRS used nonmetro data to approximate need for rural areas. We have included only nonmetro very low-income housing conditions to show the severity of the problem, and therefore the requirements for assistance:

Occupied inadequate units	1,735,000
Occupied crowded units	227,000
Occupants with a cost burden	2,513,000
Total with housing problems	4,475,000
Percent of total occupied V.L.I. units with housing problems.	59.2%

The CRS study also estimated annual rural area housing requirements and production for the period 1986-1990:

Requirements:

Additional households	350,000
Replacement units	230,000
Vacancy/Mobility	45,000
Total	625,000

Production:

Housing starts	300,000
Mobile homes shipments	200,000
Conversions and rehabilitations	50,000
Total	550,000

The result is a 75,000 annual unit production shortfall at a time when 59 percent of very low-income households already have housing problems. It is very probable that in a market this tight, very low-income tenants will be displaced in increasing numbers because of pressures to provide housing for those able to pay more.

C. Cost of Replacement

When considering the impact of removing subsidized units from the assisted low-income housing stock, it is important to review replacement cost.

- The average 1963 per unit cost (the first year of the program) was $4,875.

- The average cost for units produced between 1963 and 1979 (the unrestricted prepayment period) was $17,206.

- The average for 1985 was $31,999.

- The HAC estimate for 1987 is $ 34,084.

It is unsound public policy to permit the loss of assisted housing which must be replaced at almost twice the original capital cost. This does not do justice to current residents of Section 515 housing, and is patently unfair to those future generations of Americans who must pay the increased costs.

D. Solutions

Retroactive Restrictions. The 1980 analysis of retroactivity and breaching government contracts was oversimplified. Attached is a report by HAC consultant Art Collings. He points out the FmHA Section 515 contractual complexity where some criteria in the law serve to question the current prepayment process. Certainly not at issue is Congress' legal right to pass laws retroactively changing the character of regulations. His report referenced legal cites to court decisions known to Congress in 1979. The simple truth is that Congress is entitled to protect the public need and to legislate necessary changes in the public interest.

The Purpose for Section 515. The Rural Rental Housing legislation had its origins in the Senior Citizens Housing Act of 1962. Approximately one-third of all Section 515 units are exclusively rented to senior citizens. Occupancy eligibility is limited to very low, low and moderate-income households, with income limits essentially those of the Section 8 program. For the sole purpose of providing affordability for those eligible citizens in need of decent housing, the law provides 50 year mortgages, 1 percent interest, and, to a more limited degree, rental assistance subsidy. In addition to direct subsidy, FmHA employees provide a large amount of staff time and other government resources. The government has a sizeable investment in long-term low-income housing. The primary purpose of that investment is to provide decent housing for rural citizens unable to otherwise afford or obtain such housing.

Private investors in the Section 515 program are required to contribute only 5 percent of development cost and to have an additional 2 percent for initial operating expenses. Investors then borrow the balance at government subsidized very low interest rates (essentially 1 percent) and 50-year terms from FmHA. The investors are provided this financial advantage for only one purpose: to produce decent, safe, affordable housing for eligible tenants. Under the current law, owners or borrowers of pre-December 21, 1979 projects may choose to displace tenants any time they feel it profitable to do so. Those with post-1979 projects must normally wait 20 years to do the same. Neither is in the best interest of rural low-income families in need of adequate shelter.

CONCLUSION

HAC supports a long-term solution. We strongly endorse the legislation drafted by the National Rural Housing Coalition (NRHC) and urge the members of this subcommittee to incorporate it into legislation.

The key features of the NRHC proposal, contained in their testimony, are as follows:

i) Owners wishing to prepay must offer the units for sale, for a one year period, to a public or private nonprofit organization. If no organization exercises their right to purchase, the owner may do as they see fit.

ii) The RHIF should finance buyouts and hold the rents of tenants harmless.

iii) All exceptions contained in present law or the House measure, HR-4, should be eliminated

In conclusion, I wish to thank the subcommittee for this opportunity to appear before you. I again urge you to support long term solution of the prepayment problem.

I would be happy to respond to any questions you may have.

Appendix A

California Prepayment FY 1984-1986

36 Projects
1158 Units
816 Rental Assistance Units

New rental data are available on 29 of the 36 projects and provide the following averages for comparison:

	Plan II Basic Rent*	New Rent	Average Increase
1- Bedroom units (27 projects)	$ 186	$ 344	$ 158
2- Bedroom units (25 projects)	221	405	184
3- Bedroom units (9 projects)	$ 230	$ 481	$ 251

* It is important to note that 71.0% of the tenants (816 of 1,158 units) received rental assistance and could not afford the basic rent which has increased by 83.3% to 109.1%.

Reduction in Subsidy:

In addition to the loss to individual tenants, there was a net loss of 207 rental assistance units during the period.

R.A. Units lost	816
New RA Units 1984-1986	609

Note: Only 77 of the 609 RA units for new projects were provided in 1986. New RA continues to shrink as prepayment continues to increase.

Section 515 Loans Paid in Full FY 1966-1986(a)

1966	1
1967	1
1968	0
1969	8
1970	15
1971	20
1972	34
1973	47
1974	40
1975	20
1976	54
1977	111
1978	134
1979	92
1980	82
1981	52
1982	53
1983	127
1984	158
1985	119
1986	142
1986 Pending	57
Total:	1,129

(a) Source FmHA Report 852-B. Note the number here may represent a larger number of loans reported as obligated, since initial and subsequent loans on same projects were included in HAC report on obligations.

(b) No data computer available for FY 1985 and 1986. Information switched from 852-B to new AMAS computer system, but no programming completed. Regular 852-B files for 1985 were lost. Numbers shown for 1985 and 1986 are from an August, 1986 FmHA poll of its state offices. The data are preliminary and not verified.

Note: Preliminary unit count for units lost to prepayment in FY 1984-1986 is 5177.

FmHA Section 515 Closed and Operational Units 8/8/86

	Projects	Units
TOTAL	15,829	357,318
Full Profit	1,662	19,999
Percent of Total	10.5%	5.6%
Limited Profit	9,732	261,224
Percent of Total	61.5%	73.1%
Non Profit	4,435	76,095
Percent of Total	28.0%	21.3%

Average Units Per Project:

Total	22.6
Full Profit	12.0
Limited Profit	26.8
Non Profit	17.2

Section 515 No. Loans and Dollars for 1963-1979 and 1963-1985

Note numbers are compared from two sets of data which vary slightly.

	From State by State Data Year by Year	From National Totals, Year by Year
Total Loans 1963-1985	18,258	19,129
No. Loans 1963-1979	11,132	11,152
Percentage of Total, 63-79	60.97%	58.3%
Total Dollars 1963-1985	$8,623,804,050	$8,623,804,050
Dollars 1963-1979	$3,300,079,330	$3,300,077,530
Percentage of Total, 63-79	38.27%	38.27%
Total Units 1963-1985		366,406
Units, 1963-1979		191,794
Percentage of Total, 63-79		52.34%
Average Cost Per Unit:		
1963		$ 4,875
1963-1979		$ 17,206
1985		$ 31,999
Estimated for 1987		$ 34,084
Number loans prepaid 1963-1984	1,001	1,001
Percent of total made 63-79	9.0%	9.0%

SEP 25

MULTIPLE HOUSING LOANS DURING FISCAL YEARS 1964 THRU OCT. 18, 1982

STATE	PRE 1979 PREPAID PROJECTS	PRE 1979 PREPAID UNITS	PRE 1979 PREPAID RA UNITS	PRE 1979 PREPAID SEC 8	POST 79 PREPAID PROJECTS	POST 79 PREPAID UNITS	POST 79 PREPAID RA UNITS	POST 79 PREPAID SEC 8
AL	13	108	0	20	0	0	0	0
AZ	5	56	16	0	0	0	0	0
AR	6	69	4	0	1	1	0	0
CA	50	1150	746	0	0	0	0	0
CO	3	20	0	30	0	0	0	0
DE	0	0	0	0	0	0	0	0
MD								
FL	1	8	0	0	0	0	0	0
GA	7	86	0	32	2	12	0	32
ID	4	20	0	0	1	0	0	0
IL	0	0	0	0	1	2	0	0
IN	7	49	17	0	0	0	0	0
IA	24	124	1	0	4	23	0	0
KS	0	0	0	0	0	0	0	0
KY	0	0	0	0	0	0	0	0
LA	1	42	0	0	2	16	0	0
ME	9	69	12	0	0	0	0	0
MA	22	294	64	6	1	16	0	0
CT								
RI								
MI	10	147	59	0	0	0	0	0
MN	21	266	37	31	0	0	0	0
MS	26	261	61	20	2	2	0	0
MO	3	162	0	162	0	0	0	0
MT	1	6	0	0	0	0	0	0
NE	1	4	0	0	0	0	0	0
NJ	2	34	0	0	0	0	0	0
NM	1	46	0	45	0	0	0	0
NY	7	132	16	20	2	22	0	0
NC	27	176	35	0	0	0	0	0
ND	12	167	0	163	0	0	0	0
OH	2	26	0	0	0	0	0	0
OK	7	60	0	0	0	0	0	0
OR	2	36	0	0	0	0	0	0
PA	4	27	0	0	0	0	0	0
SC	12	243	0	0	1	6	0	0
SD	6	21	4	0	1	4	0	0
TN	0	0	0	0	0	0	0	0
TX	15	511	0	21	0	0	0	0
UT	3	12	0	0	0	0	0	0
NV	1	60	0	0	0	0	0	0
VT	14	227	26	0	1	3	0	3
NH								
VI								
VA	9	127	6	0	0	0	0	0
WA	3	70	26	34	0	0	0	0
WV	3	7	0	0	0	0	0	0
WI	10	316	111	18	0	0	0	0
WY	2	12	0	0	0	0	0	0
AK	0	0	0	0	0	0	0	0
HI	0	0	0	0	0	0	0	0
PR	1	14	0	8	0	0	0	0
NAT.	343	6137	1214	671	22	236	0	36

TOTALS

PREPAYMENT OF FARMERS HOME ADMINISTRATION
MULTIPLE HOUSING LOANS DURING FISCAL YEARS 1984 THRU SEPT. 15, 1986

STATE	NUMBER OF PROJECTS	NUMBER OF UNITS	NUMBER OF RA UNITS	NUMBER PREPAID IN 1984	NUMBER PREPAID IN 1985	NUMBER PREPAID IN 1986	NUMBER REQUESTING PREPAYMENT
AL	13	168	0	1	4	8	3
AZ	3	58	10	-	0	1	0
AR	12	23	4	4	4	4	0
CA	30	1156	746	3	10	12	6
CO	3	20	0	1	0	2	1
DE	0	0	0	0	0	0	1
MD							
FL	1	6	0	1	0	0	0
GA	9	133	0	-	3	4	0
ID	6	28	6	1	1	3	0
IL	1	2	0	0	0	1	0
IN	7	49	17	0	2	8	0
IA	28	147	4	3	6	19	0
KS	0	0	0	0	0	0	0
KY	0	0	0	0	0	0	1
LA	3	60	0	2	1	0	0
ME	9	67	12	4	4	1	2
MA	23	342	64	4	11	8	1
CT							
RI							
MI	16	147	39	4	0	6	3
MN	21	265	37	1	8	11	3
MS	27	263	81	9	12	8	5
MO	5	152	0	0	3	0	0
MT	1	8	0	0	1	0	0
NE	1	4	0	0	6	1	0
NJ	2	34	0	1	1	0	2
NM	1	48	0	1	0	0	0
NY	9	190	18	0	4	6	2
NC	27	195	36	9	7	11	6
ND	12	167	0	6	3	4	0
OH	2	26	0	0	0	2	2
OK	7	60	6	4	0	3	0
OR	2	36	0	0	0	2	0
PA	4	27	0	0	2	2	0
SC	13	249	0	3	4	6	0
SD	6	25	4	0	3	3	1
TN	0	0	0	0	0	0	1
TX	18	311	0	6	3	6	0
UT	3	16	0	1	0	2	0
NV	1	50	0	0	1	0	0
VT	15	230	20	1	7	7	2
NH							
VI							
VA	9	127	8	2	6	2	2
WA	3	70	26	1	0	2	3
WV	5	7	0	1	2	0	0
WI	18	316	111	1	13	4	0
WY	2	12	0	0	2	0	0
AK	0	0	0	0	0	0	0
HI	0	0	0	0	0	0	0
PR	1	14	0	0	0	1	0
NATIONAL TOTALS	366	5373	1227				

PROFIT TYPE REPORT - CLOSED AND OPERATIONAL UNITS DATE: 08/08/96

SERVICING STATE	LIMITED PROFIT		FULL PROFIT		NON PROFIT		TOTAL	
	UNITS	PROJECTS	UNITS	PROJECTS	UNITS	PROJECTS	UNITS	PROJECTS
ALABAMA	10,550	302	3,725	227	342	9	14,617	538
ARIZONA	1,199	43	198	15	1,030	21	2,427	79
ARKANSAS	4,223	165	490	48	1,939	49	6,652	262
CALIFORNIA	16,984	371	7	2	1,105	30	18,096	403
COLORADO	1,131	44	226	19	1,398	68	2,755	131
DELAWARE	2,878	86	13	2	493	16	3,384	104
FLORIDA	11,536	300	162	6	453	10	12,151	316
GEORGIA	6,033	173	990	64	388	11	7,411	248
IDAHO	3,636	184	262	35	824	54	4,722	273
ILLINOIS	9,567	630	114	23	1,468	100	11,149	753
INDIANA	9,320	416	194	12	2,774	126	12,288	554
IOWA	5,535	425	667	102	7,881	983	14,083	1,510
KANSAS	1,898	108	62	6	3,640	272	5,600	386
KENTUCKY	3,827	115	43	6	635	18	4,505	139
LOUISIANA	7,443	212	287	15	324	9	8,054	236
MAINE	5,314	265	72	16	2,347	116	7,733	397
MASSACHUSETTS	3,220	92	367	37	2,242	69	5,829	198
MICHIGAN	14,749	476	575	44	1,092	37	16,416	557
MINNESOTA	8,255	505	141	19	2,293	178	10,689	702
MISSISSIPPI	10,704	337	1,266	81	858	31	12,828	449
MISSOURI	6,408	330	915	130	10,276	600	17,599	1,060
MONTANA	2,307	145	81	7	241	22	2,629	174
NEBRASKA	1,489	127	220	23	1,222	103	2,931	253
NEW JERSEY	3,819	64	240	10	499	12	4,558	86
NEW MEXICO	1,690	39	131	10	313	13	2,134	62
NEW YORK	4,954	164	404	14	2,698	96	8,056	274
NORTH CAROLINA	13,271	334	370	62	1,423	41	15,064	437
NORTH DAKOTA	2,339	175	184	21	1,751	223	4,274	419
OHIO	10,977	275	483	28	2,252	53	13,712	356
OKLAHOMA	4,967	203	236	19	505	32	5,708	254
OREGON	4,636	174	76	5	454	17	5,166	196
PENNSYLVANIA	4,670	120	454	31	2,080	60	7,204	211
SOUTH CAROLINA	8,216	213	827	47	936	28	9,978	288
SOUTH DAKOTA	4,483	372	465	43	2,051	247	6,999	662
TENNESSEE	5,524	154	918	91	1,870	75	8,312	320
TEXAS	13,042	423	1,870	130	3,660	207	18,572	760
UTAH	2,775	115	296	38	208	10	3,279	163
VERMONT	3,357	109	541	29	486	21	4,384	159
VIRGINIA	4,437	107	332	27	501	13	5,270	147
WASHINGTON	5,964	200	333	16	868	27	7,165	243
WEST VIRGINIA	6,250	215	321	25	368	17	6,939	257
WISCONSIN	5,268	338	367	59	5,454	265	11,089	662
WYOMING	1,194	45	66	8	394	16	1,654	69
ALASKA	618	27	8	2	60	3	686	32
HAWAII	480	14	0	0	586	11	1,066	25
PUERTO RICO	88	1	0	0	1,341	16	1,429	17
NATIONAL TOTALS	261,224	9,732	19,999	1,662	76,095	4,435	357,318	15,829

NUMBER OF UNITS BY STATE FOR APP LOANS PRIOR TO DEC 21,1979

7:28 WEDNESDAY, SEPTEMBER 17, 1980

	NUMBER OF PROJECTS	TOTAL UNITS	RENTAL ASSISTANCE UNITS	SECTION 8 UNITS
NAT TOTAL	3023	159534	3313	28286
STATE				
ALABAMA	259	6108	0	1108
ALASKA	20	431	0	0
ARIZONA	32	817	0	50
ARKANSAS	93	2164	60	610
CALIFORNIA	117	4519	0	1232
COLORADO	53	1091	312	434
CONNECTICUT	35	956	0	90
DELAWARE	3	335	82	11
FLORIDA	123	5341	0	483
GEORGIA	105	1542	0	279
HAWAII	6	338	59	98
IDAHO	197	3116	0	329
ILLINOIS	341	5332	348	709
INDIANA	278	5853	0	1142
IOWA	1233	10570	0	842
KANSAS	175	2347	0	508
KENTUCKY	63	1391	0	537
LOUISIANA	43	1438	0	280
MAINE	162	3515	114	316
MARYLAND	27	921	0	299
MASSACHUSETTS	21	974	3	420
MICHIGAN	220	7636	1775	1737

(CONTINUED)

NUMBER OF UNITS BY STATE FOR APP LOANS PRIOR TO DEC 21,1979

STATE	NUMBER OF PROJECTS	TOTAL UNITS	RENTAL ASSISTANCE UNITS	SECTION 8 UNITS
MINNESOTA	425	5904	0	962
MISSISSIPPI	177	4433	0	973
MISSOURI	568	9216	0	716
MONTANA	75	1269	3	224
NEBRASKA	126	1535	0	191
NEVADA	15	493	116	30
NEW HAMPSHIRE	41	1349	0	549
NEW JERSEY	52	2467	0	119
NEW MEXICO	25	892	0	149
NEW YORK	116	3044	0	1333
NORTH CAROLINA	201	6996	0	1389
NORTH DAKOTA	125	3135	0	451
OHIO	202	7786	192	1750
OKLAHOMA	81	1571	0	127
OREGON	104	2773	0	259
PENNSYLVANIA	112	4054	0	999
RHODE ISLAND	2	79	0	0
SOUTH CAROLINA	85	2774	0	966
SOUTH DAKOTA	448	4407	0	416
TENNESSEE	134	2234	66	304
TEXAS	355	7827	266	1110
UTAH	54	491	3	79
VERMONT	35	576	0	161

(CONTINUED)

NUMBER OF UNITS BY STATE FOR APP LOANS PRIOR TO DEC 21,1979

7:21 WEDNESDAY, SEPTEMBER 1

STATE	NUMBER OF PROJECTS	TOTAL UNITS	RENTAL ASSISTANCE UNITS	SECTION 8 UNITS
VIRGINIA	71	2586	0	452
WASHINGTON	147	4232	0	896
WEST VIRGINIA	50	1267	0	80
WISCONSIN	336	5667	0	1453
WYOMING	34	917	0	155
GUAM	1	50	0	50

Appendix C

Public Policy for Rural Rental Housing and the Prepayment of FmHA Section 515 Loans

By Art Collings (a)

It has been national policy since the nineteen sixties to rely on private sector ownership of subsidized rental housing, including Farmers Home Administration (FmHA) rural rental housing. Perceived problems, as well as some real problems, and budget considerations have caused Congress to gradually eliminate publically owned housing construction. The notion that private entrepreneurship would be less costly was transformed into housing programs dependent on government subsidy contracts and increasingly tied to the concept of investor tax avoidance. HUD rental housing programs included a twenty year contract for retention of housing it financed as low income stock. The FmHA Section 515 housing is somewhat more complicated, in terms of low income retention, and is explained in more detail, later. In any event, as the twenty year HUD contracts and/or tax shelters have ended some, if not much, subsidized housing has been converted to other than low income use.

The FmHA Section 515 program was born in the nineteen sixties and has also offered lucrative tax advantages to its investors. It is more complicated in that (1) Section 515 is a direct loan program of the FmHA, (2) private owners need only provide a 5% investment, and (3) public and nonprofit owners may receive one hundred percent financing. Section 515 is essentially a one percent loan over a fifty year term. In return for these terms and conditions private owners agree to limit their profit to eight percent on initial investment and to serve low and moderate income tenants. Another difference, indeed a complication, is that the law initially contained no 20 year low-income provision and as amended specifically permits prepayment on loans made prior to December 21, 1979. The offset (against the eight percent return) of one percent interest over a fifty year term, and tax avoidance has proved appealing to investors. Seventy three point percent of the 357,318 closed and operational Section 515 units are owned by limited profit borrowers. Only twenty one point three percent are owned on a not for profit (including public) basis.

Privately owned and federally subsidized housing is very expensive, and particularly so when, as is most often the case, tax avoidance (shelters) is part of the deal. Such housing has proved so expensive that the Congress has, in recent years, substantially curbed those programs they didn't eliminate. The search for less costly programs has yielded alternatives with far less benefit or protection for the low income consumer. Privately owned low-income housing, achieved through short term subsidy contracts and tax avoidance, is not only costly, and basically unfair, in that it gives unnecessary advantages to the wealthy, but has a questionable duration. It is poor public policy to invest in housing that can be converted from low income stock at the end of twenty years or whenever accelerated tax benefits are exhausted or less advantageous.

In 1979 Public Law 96-153 was passed which limited, almost prohibited, prepayment of Section 514 and 515 loans; for 15 years if unsubsidized and 20 years if the loan was subsidized. Developers and investors for loans already on the books decried the fact that they entered into an agreement with the Farmers Home Administration (FmHA) requiring them to refinance (known as graduation by the agency) and thus requiring prepayment as or when able. The spector of government reneging on contractural agreements became the core issue, overshadowing why the 1979 legislation was passed and in 1980 Public Law 96-399 provided for repeal of retroactive prepayment limitations (prior to Dec. 21, 1979).

A re-examination of the issues, and the law, does not totally support the breach of contract contention, in so far as the law was silent on retention term and the regulations did contain reference to refinancing. While the contract issue cannot be completely discounted, it is not overriding when placed in proper context. Please consider the following:

(1) Section 515 does state "in accordance with terms and

conditions substantially identical with those specified in Section 502, except that ___". The exceptions are not material to the prepayment issue, and Section 502 (b)(3) does require refinancing (graduation).

(2) Section 502(b)(3) specifies that the borrower will, "at the request of Secretary (emphasis added), proceed with dilegence to refinance----". The loan agreement (the document on which the contract argument rests) also states clearly that refinancing is required at any time it appears to the government that the borrower can obtain a loan upon reasonable terms and conditions etc, "upon request from the government" (emphasis added) the borrower will apply for, take all necessary actions to obtain and accept such refinancing.

(3) Section 502 is also not self inclusive. Section 502(a) refers to Section 501 with regard to eligibility of the applicant.

(4) Section 501(c)(2) states "that he is without sufficient resources to provide the necessary housing and buildings on his own account; and (3) that he is unable to secure the credit necessary for such housing and buildings from other sources upon terms and conditions which he could reasonably be expect to fulfill."

(5) Many limited profit applicants did have resources or the ability to secure credit to develop housing of the type FmHA would finance under Section 515. However, eligibility was based on their ability to develop housing that low and moderate income tenants, eligible under FmHA guidelines, could afford.

(6) Section 501 and 502 was initially written for borrower-occupants. In applying Section 501 and 502 provisions to Section 515 borrowers, the law certainly appears to indicate that the eligibility of the borrower is conditioned to that of the intended occupant, the ultimate tenant.

(7) Since Section 515 housing is intended to benefit low and moderate income tenants, and the eligibility of the owner (borrower) is conditioned to providing them affordable rents, one must look hard to find any intent that borrowers may prepay at their option. The law and the FmHA loan agreement states that the Secretary will request them to refinance under specified conditions. Nowhere in the contract does FmHA require or authorize borrowers to be the initiator of refinancing activity.

(8) Moreover, Section 502(b)(3), in requiring the Secretary to request refinancing, states "wherever the Secretary determines, in light of the borrower's circumstances,

> including his earning capacity and the income from the farm, that he is able to do so upon reasonable terms and conditions". Once again the occupant of the housing is being advised when they must refinance. The reference to income can only be applied to tenant income with regard to Section 515, particularly in light of the fact that only tenant incomes, not the borrower's, were considered for eligibility purposes.

Nowhere in the housing law, prior to 1979 is there any indication that Section 515 borrowers could prepay at their own option. Niether is there anything in the legislative history that suggests this should be the case.

My final argument pits the 1980 amendment (Section 502(c)(2) against Section 501(g) which states "the programs authorized by this title shall be carried out, consistent with program goals and objectives so that the involuntary displacement of families and businesses is avoided." Section 502(c)(2) states _If_ any loan made or insured -- is prepaid. Section 501(g) states that programs _shall_ be carried out to avoid involuntary displacement.

The breach of contract is only one of many issues. Furthermore the contract calls for the Secretary to request refinancing (prepayment). The law clearly intends, in the case of Section 515, that this only be done when the income and condition of the tenants is considered and displacement does not occur. These facts alone are justification for a moratorium on prepayment. Surely, in establishing a 50 year term, interest subsidy down to one percent, rental assistance, and targetting to very low income tenants the Congress never intended that owners might use this money solely to their own advantage and drop out of the program at will.

Even if the contract issue were overriding, Congress has the right (in this case I believe they have an obligation) to pass retroactive legislation which changes existing rules and contractural obligations. The 1986 Tax Act is certainly a good example of Congress doing just that, in what it believes to be for the public good. The National Rural Housing Coalition in its May 4, 1979 testimony before the Senate Rural Housing Subcommittee provided a background memorandum which included the following references:

> "A United States Court of Appeals has held that when provision of a contract are contrary to even a new concept of public policy not foreseeable when the contract was made, the contract becomes illegal and cannot be enforced. Massachusetts Mutual Life Insurance Co. v. Sec. 151 F. 2d 424 (8th Cir. 1945), cert. denied, 327 U.S. 795 (1945).
>
> Contracts may create rights of property, but, when contracts deal with a subject

> matter which lies within the control of the Congress, they have a congenital infirmity.
> [*Norman* v. *Baltimore & Ohio RR Co.*, 294 U.S. 240 (1934).]

A similar situation was alleviated through legislation that was subsequently upheld by the U.S. Supreme Court in *FHA* v. *The Darlington*, 358 U.S. 84 (1958). Then the Court held that a statute that prohibited the use of federally insured veterans housing for transient renters did not violate the due process rights of the owners who wanted to rent the housing to transients, even though the statute was passed *after* the property had been insured and the owners had begun to use the property as a hotel. The court stated that the original act was passed

> to aid veterans and their families, not.. to promote the hotel or motel buisness.. and therefore the new law did not impair any vested rights of the owners.
> [358 U.S. at 87 and 91.]

Section 515 of the Housing Act of 1949 does not vest borrowers with the right to prepay in a manner which would deny beneficiaries access to decent housing.

> Neither can such a right be vested through loan agreements flowing from it. If Congress were in so many words to restate that policy, no existing right would be impaired. Borrowers of Section 515 funds could prepay loans as long as the prepayment did not deny beneficiaries of their right to occupy decent housing."

Congress must make a new public policy statement. It must decide on what is the overriding purpose of Section 515 - to provide modest housing for low and moderate income tenants, or be primarily a financial investment mechanism. There must be a choice because one of the two groups, tenants or investors will be adversely affected. Right now it is the tenants who are being harmed. In my opinion Section 515 was enacted, and amended, as a public vehicle to help low and moderate income tenants in need of decent, affordable shelter. If the FmHA erred in entering into contracts with investors, which implied they could leave the program at will, and without regard to the well being of the tenants, those contracts should not be upheld at the expense of tenant well being.

Tenants are being displaced by Section 515 borrowers who prepay their loans. It must stop. If someone must suffer inconvenience, and/or the right to accelerate profit, it must be the owners/investors. The tenants have the least capability for absorbing adversity and are the class for whom the law was passed.

(a) Art Collings, is a member of the Rural Housing Coalition, the Rural Study Group, a Consultant to the Housing Assistance Council, and formerly Special Assistant to FmHA Administrator Gordon Cavanaugh.

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
BEFORE THE
SENATE BANKING COMMITTEE
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

Decline In the Supply of Rental Housing

June 5, 1987

The National Association of Home Builders (NAHB), a trade association representing 147,000 members is pleased to have this opportunity to submit a statement for the hearing before the Subcommittee on Housing and Urban Affairs on the Decline in the Supply of Rental Housing. We respectively request that this statement be included in the hearing record.

BACKGROUND

In May 1986, the National Association of Home Builders published a report entitled Low- and Moderate-Income Housing: Programs, Problems & Prospects that provided a comprehensive analysis of the housing environment for low- and moderate-income housing along with a discussion of a wide range of policy issues in that area. In particular, this study examined the issues involved in maintaining, managing, and preserving the stock of government assisted and public housing.

We believe that the federal government has a continued important role to play in housing many low income families. Federal action is needed not only to aid lower income families who lack decent and affordable housing, but is also needed to retain and upgrade the existing stock of privately owned and federally assisted rental housing.

We make such a statement while recognizing that large federal deficits jeopardize the potential for continued economic growth. These deficits burden most heavily the interest-sensitive sectors such as housing. Continued deficit reduction, therefore, is key to making housing affordable for all Americans. We realize that restrictions on federal housing assistance programs are inevitable in an environment of fiscal responsibility. However, we also believe that budget-balancing must be approached on an even-handed basis and should not be achieved through disproportionate reductions in programs that provide housing assistance for lower-income citizens. Attention to housing problems is dictated both by established national housing goals and by the need to avoid social frictions stemming from housing difficulties.

As this Subcommittee is well aware, federal housing assistance has taken a number of forms over the last fifty years since the earliest public housing projects were built. Clearly, this nation has made a major investment to establish a stock of government assisted rental housing reserved for low-income households. At current average development costs of roughly $40,000 per rental housing unit, the assisted rental stock, excluding Section 8 Existing and Voucher Units, would cost in excess of $130 billion to replace. The retention and sound management of this housing stock are important, indeed vital, for the well-being of both the households served by those units and also those who would have to compete for housing with those displaced by any reduction in the assisted housing stock.

For purposes of this hearing, our statement focuses on those multifamily projects receiving assistance under

- Section 236,
- Section 221(d)(3) BMIR, and
- FmHA Section 515

Together, these programs comprise roughly 1 million housing units or approximately 25% of all federally assisted rental units. These categories of units are faced with three potential concerns:

1) The need for major rehabilitation expenditures;
2) The termination of Section 8 contracts; and
3) The end of low-income occupancy and rent restrictions through prepayment of the subsidized mortgage.

I will present each issue, followed by a discussion of some policy alternatives.

NAHB conducted an analysis of these issues and examined a small sample of assisted projects. This analysis was based on information provided by HUD on the number of projects, by age and by type. A field study of 16 projects in 4 selected cities - Boston, Chicago, Jacksonville (FL), and Los Angeles - was conducted by an independent consulting firm. While this sample was much too small to be taken as representative of the true situation, even these few cases illustrated for us the problems facing the existing stock.

Recently, more of the information needed to analyze the situation properly has become available from two studies conducted by HUD. The first was a study of the older private assisted stock, including an assessment of the replacement and repair needs of 500 projects. It did not, however, identify the market potential of the projects. The second study asked the staff of the HUD Area Offices to classify projects with respect to the likelihood of prepayment. Both studies covered only the FHA-insured portion of these programs, thus omitting projects with state mortgage insurance or none at all.

MAINTENANCE AND REHABILITATION NEEDS

The condition of properties can be expected to vary widely, depending on their location, the tenants and management, and whether the rents have been able to provide for replacement needs. Special attention will be needed for those projects with precariously low replacement reserves or which required Flexible Subsidy or other funding from HUD to meet deferred maintenance or rehabilitation needs. The resale process during the period 1981-1984 provided funds for some projects to catch up on maintenance and/or replenish reserves. This infusion of funds was often a business decision of the new owner, but in other cases it was the result of negotiation to get HUD approval of the sale. Such HUD leverage would end if the insured loans were prepaid. However, for the moment, changes in the tax laws have so undermined the tax benefits of ownership of low-income housing that few transactions are taking place at this time.

In our limited survey, most of the projects were reasonably well maintained, but many had very low reserves. The HUD study found a very similar result. However, since the time of both of these studies, the *incentive* for owners to invest additional capital into the maintenance and rehabilitation of these projects has fallen sharply, since the tax benefits have been prospectively and retroactively decimated by tax law changes. We, therefore, feel that the maintenance and replacement situation should be carefully monitored over the next few years.

TERMINATION OF SECTION 8 LMSA ASSISTANCE

The non-renewal of the HUD Loan Management Set Aside (LMSA) contracts could undermine the short-run solvency of many projects and put them into default. Default would not be surprising, because almost all of the older LMSA contracts were intended primarily to avert default in the 1970's, either because of management problems, or because operating costs - particularly for energy - rose much faster than tenants' ability to pay.

For those units in a project placed under LMSA contracts, the project was to be paid no more than its usual rent (the Base Rent in the case of Section 236), but the owner did not have to find a tenant who could both afford the rent and meet the income limits. Instead, HUD would make up the difference between the rent and 30 percent of the income of Section 8 eligible tenants. The LMSAs also allowed tenants to absorb rent increases needed to meet unexpected increases in operating costs and allowed the project to serve families with even lower incomes.

While these projects were not viable without LMSAs at one time, some may be viable today without the LMSAs. Apparently, the privately assisted stock is currently in reasonably good financial condition. HUD reports that foreclosures have been at very low levels the past few years. This trend probably reflects a number of influences. Increases in operating costs have moderated, the market for tax shelters was strong, and most of the weak projects have either already been foreclosed or continue to be supported by LMSA contracts. With the enactment of tax reform, however, the resale market has been destroyed for these projects except for ones with market-rate prospects.

The effect may be enough in some projects to maintain occupancy without further assistance. Occupancy would also tend to benefit from the recent increases in market rents. It is likely, though, that an end to all LMSA assistance will prompt significant mortgage defaults and perhaps dislocation for both households assisted by the LMSAs, as well as all other tenants in these projects.

This view is strongly supported by the results of our survey of project owners. Over half of the owners stated that their projects need such continued LSMA assistance (see Attachment I).

HUD has not studied this issue, but instead has indicated that eligible tenants in assisted units will receive vouchers as the Section 8 contracts expire. NAHB doubts that vouchers are a sufficient response to the situation, either for those projects still reliant on Section 8 assistance, or for some of the current tenants who do not meet income eligibility requirements for vouchers.

PREPAYMENT OPTION

Some Section 221(d)(3) and Section 236 projects are in the opposite situation. Whether or not they once needed LMSA assistance, they currently enjoy a strong market for their units and could earn a better return at market-rate rents, without the interest rate subsidy or the restrictions on return under the programs. These projects may be ripe for removal from the assistance programs by their owners and probably from the low- and moderate-income housing stock entirely.

In addition to the prepayment potential of these older assisted projects, there is a good chance that some units contracted for under the Section 515 program will be withdrawn in the future. This is permitted under contracts entered into before 1980.

Of the three concerns, this issue has received the greatest amount of attention. HUD did a study and concluded that about 60% of the relevant HUD-assisted units would eventually be eligible to prepay, but that only about two out of five of these would be likely to prepay. This last group is only 25% of the total 221(d)(3) and 236 inventory, but still amounts to over 150,000 units containing at least a half million persons.

POLICY CRITERIA

The NAHB case studies and the HUD studies confirm the existence of the spectrum of expected problems. There are significant numbers of projects in all categories, from those ready to go market rate to those totally dependent on continued LMSA assistance to those facing difficulty with maintenance. The results clearly suggest that the issue is not uniform across projects. Circumstances vary so much across projects that no single solution can be recommended at this time. However, several criteria can be applied to the general analysis of policy options.

PROTECTING THE CURRENT TENANTS

A first priority would be to prevent a reduction in the housing quality of the currently assisted households, and preferably to avoid their relocation. This is more difficult than it appears. For example, one basic strategy would be to give Section 8 Existing certificates or Vouchers to all eligible residents of projects that prepay and convert to market-rate rents. But, many of these residents would have to relocate because their rents would be higher than allowed under the Section 8 Existing program. This will put them in competition with other low-income households for moderately priced units.

Many tenants in those projects most likely to convert to market-rate would not qualify under the very low-income requirement for Section 8. They would simply have to bear the full burden of market rent on their current units or move elsewhere.

The fate of the tenants is unclear if a project defaults to HUD after the ending of Section 8 Loan Management contracts. It seems likely that the process of foreclosure and disposition would be costly for all parties involved. In addition, there is a statutory requirement in Section 203 of the Housing and Community Development Amendments of 1978 to preserve those projects disposed of by HUD as "available and affordable" to low and moderate income households. If projects fail because of loss of LMSA assistance and become HUD-owned, they will become subject to this provision.

FISCAL EFFICIENCY

Fiscal efficiency is a second consideration in either expanding incentives in order to retain projects or in renewing current assistance. For example, a project with tremendous market potential for condominium use may require greater incentives than the cost of the most expensive alternative forms of assistance (plus the costs of the relocation of the current residents). Similarly, renewing LMSA contracts is conceivably more costly than at least some alternative form of assistance.

What might be the costs of retaining a project that has market rate potential? At minimum, these costs would include continuation of the current subsidy. In the case of BMIR and Section 236 units, the subsidy includes a below-market rate of interest on the remaining principal from the original mortgage.

RENT STRUCTURES IN PREPAID CALIFORNIA SECTION 515 PROJECTS[a]

Name of Project	County	# Units	# RA Units	Old Rent(s)	New Rent(s)
El Manacor De Cortez	San Diego	80	38	$ 230-$ 260	$ 375-$ 425
La Galiana de Cortez	San Diego	48	24	240 - 285	375- 425
Thomas McLaughlin #4	San Luis Obispo	17	7	190-225-260	400-535-675
Thomas McLaughlin #5	San Luis Obispo	17	7	190-230	375-450
Thomas McLaughlin #8	San Luis Obispo	18	8	190-225-260	400-535-675
Thomas McLaughlin #10	San Luis obispo	17	7	200-220-255	350-450-565
Summerwood Apts.	San Diego	32	0	160-185	400-425
Tropicana Village	Kern	48	20	135-175-190	260-325-360
Cork Elm #1	Kern	12	9	160-200-230	215-275-315
Cork Elm #2	Kern	16	12	160-200-230	275-325-375
Cork Elm #3	Kern	8	4	160-200	275-325
Alliconte Gardens	Merced	30	0	147-172-185	230-275-350
Whispering Oaks	Sacramento	33	20	230-260	375-420
Beaumont Park Valley Apts.	Riverside	33	22	150-195	340-375
Elsinore Shores Apts.	Riverside	20	11	175-215	375
Ridgecrest Apts.	El Dorado	46	39	210-225-245	375-425-525
Sabana Aire de Cortez	Riverside	48	24	246-271	375-425
Copeland Creek Apts.	Sonoma	115	86	205-226	395-425
Desert Manor Apts. I & II	San Bernadino	112	111	215-255	375-425
Willow Heights Apts.	San Joaquin	33	21	190	275
Elk Grove Apts.	Sacramento	50	41	180-200-220	Not reported
Vista De San Jacinto I	Riverside	52	52	164	330
Vista De San Jacinto II	Riverside	52	52	161	330
Vista De San Jacinto III	Riverside	52	52	166	330
Jamestown Apts.	Toloumne	40	34	248-278-298	Not reported
Sunset Apts. I	Placer	28	24	186-202-218	300-375-425
Sunset Apts. II & III	Placer	78	71	186-202	325-400
Yucca Valley Oasis	San Bernadino	10	2	170	450
Sonoma Valley Invest.	Sonoma	36	24	160-180	360-425
Village Green I	Sonoma	41	0	198-270	400-600
Sabana Aire De Cortez	Riverside	48	48 Sec.8	315-400(b)	400-450

(a) Limited to projects with available district office reports
(b) Not basic (1%) rent. Rent 1-2% below market rent

Sample, Prepaid Section 515 Projects, FY 1984-1986(a)

State	Total Projects	Projects Reported with unit Data	Prepaid Units	Prepaid Units/w Rental Assistance	Prepaid Units/w Sec. 8	Identified Elderly Units(b)	District Office Est. Displacement Units	AMC Est. Displacement Units
U.S. Total	359	252	4,477	1,642	579	1,467	967	1,342
Alabama	18	18,	276	0	60	87	0	0
Arizona	3	1	24	10	0	9	0	10
Arkansas	11	11	63	0	0	0	10	10
California	35	32	1,266	874	85	666	560	792 (c)
Colorado	3	2	36	0	36	24	0	0
Connecticut	19	2	64	30	10	5	45	45
Georgia	12	12	192	8	112	118	8	8
Idaho	5	5	28	0	0	1	4	4
Indiana (d)	9	-	-	25	0	-	-	-
Iowa	27	1	7	7	0	0	0	0
Kentucky (d)	1	-	-	-	-	-	-	-
Maine	13	2	12	11	0	7	9	9
Massachusetts*	5	3	84	10	66	66	0	10
Michigan	11	11	165	32	0	11	13	22
Minnesota	31	9	95	11	15	24	27	27
Mississippi	28	22	281	51	20	38	5	7
New Hampshire (e)								
New York (d)	11	6	178	-	-	-	-	-
North Carolina	28	28	209	39	12	21 (b)	31	31
Ohio	3	3	87	0	59	63	0	0
Oklahoma	5	5	40	0	24	9	0	0
Oregon (d)	2	-	-	-	-	-	-	-
Rhode Island	1	1	40	27	0	0	18	27
Texas	9	9	238	0	2	66	48	78
Vermont (e)	16	16	242	17	12	57	64	120
Virginia	4	4	76	12	0	9	5	12
Washington	3	3	70	25	30	33	18	18
Wisconsin	46	46	707	456	36	153	102	112

(a) Source: 1965.90(d) reports and survey data supplied by FmHA state offices.

(b) A number of 1965.90(d) reports did not provide good data on eldery occupancy.

(c) In California a number of District Directors reported that a majority of tenants were being displaced. AMC quantified this, thus the substantial difference in numbers.

(d) Corrected data not received from these states.

(e) New Hampshire and Vermont data combined.

However, in most cases, the value to the owner of the original below-market interest differential has expanded over time at no additional cost to the government, because market interest rates have risen. Thus a typical differential on a Section 236 or Section 515 project between the 1 percent subsidized rate and the 7 to 9 percent rate on the underlying loan has widened by several percentage points with current market rates between 10 and 11 percent. Both differentials would be lost to the owner by prepaying the loan, while the government would save only the initial 6 to 8 percent differential.

If an owner considers converting to a market rate project, presumably the possible increase in rent is enough to compensate for the loss of the below-market rate. For a project with a typical outstanding loan amount of $10,000 to $12,000 per unit, that cost would be about 10 percent of the loan amount per year or up to $100 per month. Because current rents are usually only $250 to $350 for a one-bedroom apartment, a $100 increase would be easily sustained in a good location in a strong market. However, it would probably make the unit unaffordable for the current tenants.

There used to be another major cost for an owner who would prepay. Under prior tax law, a BMIR or Section 236 property automatically received advantageous tax treatment with respect to depreciation or rapid amortization of any rehabilitation expenses. These tax advantages increased the resale value of the project as long as the mortgage was not prepaid. However, the

Tax Reform Act of 1986 stripped most of these tax incentives away, leaving only a tax credit which is untried and may be unworkable.

These incentives of subsidized mortgage rates and tax preferences may keep many project owners from exercising their prepayment option. However, these incentives could be enhanced significantly at a relatively low cost and thereby further minimize the likelihood of prepayment. Those projects with the greatest market potential are often in cities or locations where housing is generally expensive. If rents were permitted to rise marginally from their current regulated levels, owners could receive a significantly higher limited dividend while tenants, although assuming a heavier rent burden, probably would be significantly better off than if they had to move. The amount of the rise in the permitted limited dividend could be based on the specific market conditions of each project.

Another alternative incentive would be to allow owners to renew the depreciable basis of the project without bearing the high cost of selling the property or paying taxes on previous depreciation. The costs of selling a property run between 5 and 10 percent of the value of the project and capital gains taxes may be as much as 33 percent. Currently both have to be paid in order for a new owner to renew the depreciation expenses. A provision that permitted a renewed appraised basis after 20 years of continuous ownership could provide significant incentive not to take a property out of the assisted housing status.

Fiscal efficiency is also a criterion in choosing to renew Section 8 LMSA assistance. It appears that the renewal of the Section 8 LMSA contracts is a fiscally efficient way of supporting low-income housing in those projects continuing to need the assistance. For example, in the 1987 Appropriations Act, LMSA contracts are budgeted for $3,521 a year, compared with $5,273 a year for Section 8 Existing units. Part of this difference is attributable to the subsidized interest rate on these projects. But even accounting for this, it is unlikely that the full cost of assisting a unit through a LMSA contract is much more than through a Section 8 Existing contract or housing voucher.

* * * * *

In conclusion, both the federal government and many private owners of assisted rental housing will soon face the choice of terminating or continuing relationships under which subsidized private units are provided to low-income tenants. Federal policy should work toward maintaining these relationships by renewing assistance contracts and providing incentives for continued participation by private owners. At the same time, Congress must avoid the abrogation of contractual provisions entered into in good faith by private owners.

I thank you for the opportunity to present this information and our views to this subcommittee. The National Association of Home Builders looks forward to continuing dialogue on this important issue and offers any support the Members and staff may desire.

National Leased Housing Association
serving America's rental housing needs
NLHA

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STATEMENT OF WILLIAM BERNSTEIN
PRESIDENT, NATIONAL LEASED HOUSING ASSOCIATION
BEFORE THE HOUSING AND URBAN AFFAIRS SUBCOMMITTEE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

June 5, 1987

My name is William Bernstein, Managing Director of Drexel Burnham Lambert, Inc., New York, New York and President of the National Leased Housing Association on whose behalf I am submitting this statement for the hearing record.

The National Leased Housing Association is unique among housing organizations in that our membership is comprised of representatives of both the public and private sectors. We number among our 725 members local housing authorities, state housing finance agencies and non-profits as well as developers, managers, and financiers of federally assisted low and moderate income housing. Accordingly, we present the perspective of both the public concern that low income tenants continue to be housed in decent accommodations balanced by strict adherence to the contractual rights of today's project owners.

Background of the Problem

The factual background of this problem has been well documented in the June, 1986 GAO report entitled Rental Housing - Potential Reduction in the Privately Owned and Federally Assisted Inventory. This report indicates the dramatic decline in subsidized units expected during the late 1980's and 1990's assuming owners opt out of the Section 8 or Section 236 program when their contractual obligations expire. You will hear testimony and have available other studies which confirm the fact that there could be a drop of one million units in inventory from 1985 to 1995.

In order to deal effectively with the problem, we must look beyond these gross figures and focus on particular types of projects and geographical areas to see the real extent of the problem. A crucial fact to recognize is that not all owners will seek to prepay their mortgage and free themselves of their low income obligations. Indeed, the inventory of federally assisted housing falls into three basic categories:

First, concerning projects located in unattractive or declining areas or where the project is in poor physical condition, prepayment is not the problem. Indeed, the owners will be desperate to hold on to the subsidy stream from either Section 8 or Section 236. However, this assistance alone, in many cases, will not be sufficient to keep the project alive.

In a second category of projects, those in good physical condition in "hot" locations such as Los Angeles and Boston, the owner will be most likely to prepay or opt out no matter what incentives are offered him or her to keep the project in the low income stock. Accordingly, none of the incentives discussed below will really be helpful in such cases.

Third, and probably the largest category, are those projects which are borderline with respect to the economics of operation as either a subsidized or unsubsidized project. It is in these cases where some fair and realistic treatment of the owner by Congress or the administering agency can mean the difference as to whether a project stays in the assisted inventory or not.

Our discussion will focus mainly on measures to induce owners of the category three projects to keep such projects within the assisted inventory. Our suggestions are not meant to be inclusive, nor has any particular remedy been developed in full. However, we believe that the suggestions are an appropriate starting point as we begin to make decisions that will determine the quantity of our assisted inventory until the end of the second millenium. We will make references where applicable to provisions in H.R. 4, as passed by the House Committee on Banking, Finance and Urban Affairs, which we believe should be seriously considered by your conferees in the forthcoming House-Senate conference.

First and foremost, a category three owner, in making the decision whether to stay in or opt out of a subsidized project, will essentially look to the bottom line - what return is he or she receiving from the project. Under present law and regulation, this return is generally most unsatisfactory. Under the Section 236 program, an owner is limited to a 6% return on the equity in the project. In Section 8 projects placed under contract since 1979, the return is generally limited to 6% or 10% on the original equity. In the case of Section 236 projects, many of which date back to 1970, the owner's return has been frozen in dollar amounts since that time. For example, if the original equity in a Section 236 project was $100,000 when the project was completed in 1970, it yielded a 6% return then or $6,000 in 1970 dollars. Now, it yields the same $6,000, but in 1987 dollars - which are worth about one-third as much. I'm sure that no one would be happy working for the same dollar amount that they received in 1970. Yet we are asking the HUD-assisted project owner to do exactly that.

There is a simple cure for the problem, and that is to increase the amount of the equity by the inflation factor since the project's development. In that way, the owner now would be realizing the same actual return received at the commencement of the project. The revised Section 8 regulations adopted in November, 1979 allow HUD to increase the equity by the inflation factor for Section 8 projects but, to date, HUD has not chosen to escalate the amount of the equity. We see no statutory inhibition that would prohibit HUD from raising the equity on Section 221 (d)(3) or Section 236 projects so that the owner could receive a fair return.

In some Section 236 units, the amount that a tenant can pay is limited to 30% of family income, and thus any increase in rent to the owner must come out of increased subsidy payments. In many Section 236 units the rent-income ratio is not capped at 30% and the tenant would have to bear the rent increase. In any event, these increases in subsidy payments or rents are a slight price to pay to keep an older project subsidized rather than to replace it with a new project.

Second, another approach would be to allow the owner to place a second mortgage on the property from private lenders but which would be FHA-insured. Unlike the subsequent loan envisioned in the project preservation provision embodied in Sections 271-278 of H.R. 4 discussed below, here the owner would be allowed to take the cash out of the project. There obviously have to be stringent safeguards to make sure that the project does not become over-mortgaged or that the servicing of the additional debt would not pose an undue burden on the rent structure. If these difficulties can be overcome, we have a mechanism that would allow the owner to see immediate cash while still maintaining the project in the low income inventory. Certainly, if the owner is benefiting from this additional financing, he or she should commit the project to low income occupancy for an increased term.

Third, Sections 271-278 of H.R. 4 establish a new loan program to preserve existing HUD assisted multi-family housing. These sections recognize the necessity of additional financial assistance to owners of projects assisted under Section 236, Section 8, Section 221 (d)(3), rent supplement and Section 23 to make needed capital improvements to replace items that have failed or are likely to fail in the future. H.R. 4 provides for below market loans to owners for these repairs. In exchange for such funding, the owners must provide at least 20% of the capital cost and must agree to maintain the low and moderate income character of the project for the remaining life of the mortgage. We strongly support this proposal. However, we caution that its main utility will be in our category one projects - those projects where prepayment is not a viable alternative for the owner but where there is a real question that without further subsidy the owner can afford to maintain the project at all. In addition, some owners in category three may find this program attractive.

Fourth, the House Committee became deeply involved in this prepayment issue in regard to Section 515 projects which received their loan before December 21, 1979 and where prepayment is currently not subject to a twenty year lock-in. Section 307 of H.R. 4 contains a mandatory buy-out of the owner at fair market value instead of allowing the owner to prepay. In this regard, we note that the mandatory buy-out approach, even if desirable in the Section 515 context, would be financially impractical for the two million Section 8 and Section 236 units potentially eligible for such treatment within the next 15 years. However, you may wish to consider an optional buy-out program where an owner, instead of prepaying, could have the option to sell the project at its fair market value to a purchasing entity agreeing to maintain its low income character. In such case, HUD would have to make a guaranteed and subsidized loan for the difference between the fair market value of the project and existing mortgage. Such funding could prove a less expensive way of maintaining the present quantity of inventory rather than allowing the older projects to go out of inventory and be replaced by costly, newly constructed ones.

Fifth, the new low income housing tax credit provisions contained in the Tax Reform Act of 1986 could provide some useful incentives to owners who want to keep their project and do substantial rehabilitation. In such cases, assuming the availability of the credit from the state housing finance agency, the owner would receive a 9% credit for the rehabilitation expenses if the cost exceeds $2000 per unit. This is a creative use of the tax law to encourage owners to maintain a project rather than sell it. This tax credit expires at the end of 1989. If the mechanism is as successful in encouraging owners to stay in projects as we expect, then we believe that this mechanism should be made permanent.

We are aware that there are other tax incentives that could be made available to encourage the preservation of the low income nature of the project. One possible approach would be to waive or defer the capital gains tax if the owner sells the project to a subsequent owner who agrees to keep the project in low income occupancy. An analagous provision deferring gain on a Section 236 project sold to a cooperative consisting of the project tenants has been in the Internal Revenue Code since 1969 (I.R.C. Section 1039).

However, aside from the above suggestions, we are not sanguine about the Internal Revenue Code being the prime vehicle to encourage owners to stay in the low income projects. The major thrust of the Tax Reform Act of 1986 was to do away with shelters that would allow investors in low income housing to reduce their tax liability by virtue of such investments. Even if a reversal of this policy is desirable, we think realistically it will be many years before Congress will again use tax shelters in a wholesale fashion for social goals.

Sixth, in the case of Section 8, the assistance contract for the project generally expires after twenty years and some expire in as little as five years (e.g. loan management). There, it is not the question of the owner opting out. In effect, both sides are out of the deal.

There will undoubtedly be many cases in our third category, and certainly in our first where the owner would very much like a continuation of the Section 8 subsidy. In such cases, HUD should be authorized to renew these projects for five-year periods up to an additional twenty years. This would be the prime method of assuring continuation as low income housing.

In this regard, we strongly oppose the HUD approach of making vouchers available in such situations. As vouchers go with the tenant, they offer no assurance to the owner or the government that there will be continued project occupancy. Vouchers will hardly provide the inducement for an owner to keep the project for a potential low income clientele. Instead, conversion to condominiums or an upgrade to a middle market rental project will be the probable result.

We have set forth six positive ways to induce the owner to maintain the low income housing stock. We strongly believe in this "carrot approach". We are equally vehement in our opposition to the "stick approach" by abrogating an owner's right to prepay a Section 236 loan after the 20 year lock-in or to otherwise force an owner to maintain the project in low income occupancy in violation of the owner's contractual right not to do so. Congress passed such retroactive regulation in regard to the Section 515 program in 1979 only to realize the error of its ways by repealing same in 1980. A temporary reimposition of the Section 515 prepayment ban in last year's Appropriations Act has stirred a hornet's nest of controversy, pointing out to all the need to meet the prepayment problem in fair and equitable ways. As we begin to grapple with this issue with the Section 236 and Section 8 projects, let us not walk down the acrimonious path of violating the owner's contractual rights. The trust of the people in its government to honor its obligations is too important to squander in this fashion.

House Notice of Prepayment Provisions

Section 261 of H.R. 4 imposes upon the owner certain obligations to notify HUD, the appropriate state housing agency, local government and the project tenants (defined in the statute as the "interested parties") of his or her intent to prepay. Actually, the section requires two notifications - a one-year notice of intent to prepay during which time the interested parties have 150 days to make an offer to the owner. The owner has the absolute right to accept or reject such an offer. After the end of the one-year period, the owner has a right to prepay. However, an owner with a purchase offer, or refinancing commitment or a specifically determined prepayment date, is also subject to a 60- or 90-day notice to the interested parties, the time period depending on whether the owner seeks to prepay for reasons of refinancing or sale. During the 60- or 90-day period, the interested parties again have the chance to make counter proposals to the owner although the two notice provisions as may take place simultaneously. Again, the owner has the absolute right to reject the offer.

These provisions, adopted by the full Banking, Finance and Urban Affairs Committee upon an amendment by Representatives Kennedy and Erdreich, replaced provisions offered by Representative Kennedy in Subcommittee requiring an owner to "negotiate in good faith" with the interested parties before a sale or refinancing could be done. NLHA strongly opposed this provision, as it in effect was an indefinite right of first refusal in favor of the interested parties that could frustrate any sale of the project. We regarded that provision as a clear abrogration of the owner's right to prepay after the twenty-year period expires. NLHA did work closely with concerned Committee members and their staff to fashion the Kennedy-Erdreich amendment which we feel was a great improvement over what was in the Subcommittee's bill.

However, we still have serious misgivings about any measure that impedes the owner's right to prepay after the twenty-year period expires. Accordingly, we have no trouble with the one-year notice provision so long as it can be given at the beginning of the 20th year of the lock-in. We have more concern with the 60- or 90-day notice provision after the one year has expired. We will share our thoughts on this matter with you and your staff in greater depth before the conference.

In our opinion, the real challenge is not to devise ways to frustrate owners who are intent on prepaying or selling but to develop a financial mechanism that will enable the purchase of the projects by non-profits, public bodies or others who will retain the projects in low income housing. There is no escaping the fact that funding will be required to obtain this goal. We feel that the Committee's real focus should be on devising a new federal assistance program to localities and non-profits to enable them financially to purchase projects from owners who wish to sell. Otherwise, any 60-, 90- or 120-day period where offers can be made becomes meaningless if there are no funds available to make the purchase.

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Statement of Robert A. Rapoza

Legislative Director

National Rural Housing Coalition

Before the Subcommittee on Housing

Committee on Banking, Housing
and Urban Affairs

United States Senate

June 5, 1987

Owners' Plans At Sampled HUD Assisted Housing Projects

OWNERS' PLANS AT SAMPLED ASSISTED PROJECTS

METROPOLITAN AREA	PROGRAM	PROFIT (P) NONPROFIT (NP)	PERCENT SECTION 8	YEAR COMPLETED	PREPAYMENT PLANS	COMMENTS
Boston	BMIR	P	67%	1968	No option (Flex. Sub)	Needs Sec. 8
Boston	236	P	100%	1972	No option (Flex. Sub)	Forclosure w/o Section 8
Boston	236	NP	80%	1972	Not applicable	In gentrifying area
Chicago	BMIR	P		1969	Will prepay	Go market-rate or condo
Chicago	236	P	90%	1969	May prepay	Wants tax incentives to stay low-income
Chicago	236	P	--	1974	May prepay	Too early to tell
Chicago	236	NP	40%	1975	Not applicable	Needs more Sec. 8
Jacksonville (Fl.)	221(d)(3)	P	100%	1968	No option(?)	Needs Sec. 8
Jacksonville (Fl.)	236	NP	67%	1972	Not applicable	Needs Sec. 8
Jacksonville (Fl.)	236	P	100% Rent Supplement	1973	Unlikely	Need Rent Supp and tax incentives
Jacksonville (Fl.)	236	P	100% Rent Supplement	1973	Unlikely	Needs Sec. 8
Jacksonville (Fl.)	221(d)(3)	NP	100%	1973	Not applicable	Needs Sec. 8
Los Angeles	236	P	50%	1973	Will Prepay	Go market-rate
Los Angeles	236	P	–	1973	Probably Prepay	Go market-rate
Los Angeles	236	P	90%	1974	Will Prepay	Go market-rate
Los Angeles	236	P	100%	1974	Unlikely	Needs Sec. 8

Survey Conducted September 1985 for the
National Association of Home Builders

STATEMENT OF THE NATIONAL RURAL HOUSING COALITION REGARDING PREPAYMENT OF RURAL RENTAL HOUSING LOANS
SENATE HOUSING SUBCOMMITTEE
JUNE 5, 1987

Mr. Chairman, my name is Robert A. Rapoza and I am the legislative director of the National Rural Housing Coalition (NRHC). NRHC is a national membership organization which lobbies on behalf of rural low income housing needs. We appreciate the opportunity to submit this statement for the record.

As you know, we are facing a serious problem providing and retaining low income rental housing. Funding to improve housing conditions for the poor, be they urban or rural, has been dramatically reduced since 1981. In fact, the Department of Housing and Urban Development now assists only one-third of the number of new households which were assisted in 1980 and the Farmers Home Administration (FmHA) will finance about 75,000 units this year -- less than half the number produced 6 years ago.

With over 2 million economically disadvantaged rural households living in bad housing, there is a continuing need for more federal assistance. Yet, we are now also faced with the probability that some 350,000 units of rural rental housing financed through the Section 515 program will be lost in the coming years.

The most immediate problem is that current law allows prepayment at anytime for the estimated 150,000 Section 515 units financed prior to December 21, 1979. Only a Congressionally mandated moratorium on prepayments prevents loss of these units. In the three years prior to the moratorium, over 5,000 units were lost through prepayment.

However, it is important to note that projects financed after the December 1979 date will be eligible for prepayment in 20 years or 1999. According to the Housing Assistance Council (HAC), over 30,000 units will be eligible for prepayment in the year 2000.

The funding level and character of the Section 515 program changed in the 1970's. Starting in 1973, appropriations doubled virtually every year. As funding increased, the typical sponsor of rural rental housing changed from a non-profit or public body to a limited dividend corporation seeking tax breaks.

Limited dividend sponsors now make up the majority of

Section 515 sponsors and they are the most likely to prepay. If tax breaks are exhausted -- a major reason for the prepayment -- or the project can be put to a use which yields a higher return -- such as market rate units or condominiums -- in the absence of government regulation, private sector sponsors are likely to exercise the option which produces the highest return.

For profit borrowers receive a direct federal loan to finance 95% of Section 515. Beyond the 1% loan, many projects have Section 8 or FmHA rental assistance which virtually guarantees rents are paid. In short, the Section 515 program, including tax advantages, is a very good one and the private sector has taken advantage of it.

It is important to note the Section 515 program was established in a time of increasing resources for low-income housing. The 20 year use restriction for projects was added at a time when HUD and FmHA were producing about 500,000 units of housing a year.

Now times are drastically different. As we are barely willing to pay for the minimum in terms of new units, how can we permit the loss of hundreds of thousands of units, worth billions of dollars, and the displacement of so many poor and elderly persons?

The House Banking Committee has a number of prepayment provisions in its version of the 1987 Housing Reauthorization Act, H.R. 4.

H.R. 4 takes important steps regarding prepayment. The bill, limited to pre-1979 projects, establishes a program to buy out developers who wish to prepay. The legislation also sets a 20 year use restriction on pre-1979 projects.

However, the bill provides a number of exceptions which we feel are not in the best interests of tenants.

For example, by allowing prepayment 20 years from the date of the loan origination, H.R. 4 only postpones the prepayment problem. The bill would permit owners to prepay now and continue the low-income use restriction for a period that could be as short as 4 or 5 years. Certainly by the mid-1990's, 20 years after the major expansion of the Section 515 program, we will have 20-30,000 low-income units per year eligible for other uses.

H.R. 4 also allows prepayment in cases in which there are available units up to 25 miles from the Section 515 projects. For many elderly and low income households, with few transportation resources, the prospect of moving 25 miles will be horrifying.

We have other concerns with the prepayment provisions of H.R. 4. The bill does not provide in law an enforcement mechanism to ensure owners who prepay live up to the use restriction.

In addition, the bill only provides for refinancing of 5,000 units and this is to be accomplished through a separate grant program, which will require a separate appropriation. Given the increasing number of Section 515 units developed through the seventies, the 5,000 unit limit may not be adequate. In these hard budget times, gaining a separate grant appropriation may be difficult.

While H.R. 4 is a good start, its fundamental flaw is that it presumes that, sooner or later, we will lose low-income housing as private sector sponsors are permitted to prepay or the 20 year use restriction expires. The underlying principal of H.R. 4 is that the 20 year use restriction employed for post 1979 projects is an adequate policy response to the pre-1979 prepayment problem. Our view is that the 20-year use restriction is a relic of another time. We simply do not have the resources to afford replacing our current stock of rural rental housing.

As an alternative, we propose a 3 point program. Our program will provide for the permanent retention of low income housing by:

1. Requiring that any owner wishing to prepay a Section 515 first offer it for sale for a one year period to a public or private nonprofit organization. If at the end of that the nonprofit organization does not exercise this right, the owner is free to do as he or she sees fit.
2. Making available the resources of the Rural Housing Insurance Fund (RHIF), rather than a grant program, to finance buyouts and to hold the tenant's units harmless. Also needed will be funding for public and private non-profits to handled the administrative and management responsibilities of the buyout program.
3. Eliminate all exceptions provided in current law, or H.R. 4, which allows owners to prepay Section 515 loans.

Our approach is good public policy and it is good for tenants. Buying back projects at fair market value will give the owner a very good return on an investment of about 5% of the total project cost.

Mr. Chairman, the issue of section 515 prepayment and the retaining of rural rental housing is a difficult one. We urge you to closely examine our plan as we beleive that it meets the essential test of fairness for all parties involved. Owners are allowed to sell their projects, for which they received generous federal loans and tax breaks, at the fair market value. The federal government, while making a further investment in this housing, is spared the cost of replacing 350,000 units of rural rental housing. The tenants are permitted to remain in their homes.

We would welcome the opportunity to work with the Committee on this matter and thank you for the opportunity to submit this statement.

STATEMENT OF

RENTAL HOUSING ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

JUNE 5, 1987

Prepared by:
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STATEMENT OF
RENTAL HOUSING ASSOCIATION

June 5, 1987

Thank you for the opportunity to comment on the important issue before the Sub-Committee -- the removal of subsidized housing units from the inventory available to lower income families.

Two related problems are impending. In some cases, previously appropriated funds for subsidies will become fully expended. This includes both "tenant-based" subsidies (which can be used by a tenant in any qualified unit) and "unit-based" subsidies which can only benefit a tenant who resides in a designated unit.

A second problem is that some older subsidy programs allow a property owner to pay-off an assisted mortgage and use the unit for a purpose other than assisted housing. The programs involved use a form of unit-based subsidy which gives an option to the owner as to when the benefit may be ended.

Although there are two problems with many manifestations and several programs and sets of circumstances involved, the policy required to meet the need is relatively simple and uniform.

The answer, however, will require either new Federal money or a large reduction of assistance to the poor. Because the funding problem will be so acute, it is extremely important that the policy applied have the best possible benefit for each Federal dollar spent. We cannot afford the luxury of wasteful, subsidized housing programs to meet this crises!

An analysis of what to do starts with recognizing two critical realities.

1. The limited Federal money must be used to help the poor, not to help investors, developers, syndicators, lawyers and related organizations. The point seems so simple that it should not be necessary to state. Unfortunately, most of the testimony, comment and recommendations urged before the Congress will come from those who have financial or bureaucratic interests in the buildings involved in these programs.

2. The Federal government cannot unilaterally renege on past contracts. Options to pay-off mortgages and end assistance contracts were put into past contracts to reduce the cost to the government. Contracts without options would have cost more. The government cannot now demand a benefit under a contract for which it was unwilling to pay. To do so would probably be unconstitutional (as either a "taking" without compensation or a

violation of the "contract provision" of the Constitution). If done successfully, it would greatly increase the cost of inducing private parties into any long-term government contracts in the future.

The problems to be faced cannot be resolved by only regulating private sector behavior, i.e., by dictating that private parties must absorb the cost of providing housing below its market value, even when the private party has no contractual obligation to do so.

The problem is financial. To replace housing services previously financed under terminating contracts, the government must go into the housing market and purchase housing services for those who cannot afford housing. This will be a negotiated process with voluntarily participating private parties. The government must pay at least the market value of the services it wishes to purchase. The trick will be to keep the cost from rising well above that minimum amount!

Tenant-based subsidies (such as the Section 8 "finders-keepers" Existing Housing Certificate) best approximate the minimum cost approach to low income housing. Decision making as to how the Federal money is spent is delegated to the party with the greatest self-interest in getting the best return for the Federal dollar -- the low income tenant! The tenant is free to move with the subsidy, to keep shopping in the market place to make sure that the best value possible is obtained for the subsidy spent.

With a well administered tenant-based subsidy, the property owner will get little direct benefit. Primarily, the owner receives a helpful expansion of the market for his or her unit. Virtually all the subsidy goes to benefit the tenant.

When a rent subsidy is attached to a unit, something is taken away from the tenant. The tenant can no longer move if a better value for the subsidy could be obtained elsewhere. The owner is guaranteed a specific income even if the value of the unit is less than the subsidy could obtain if spent elsewhere. The benefit for the owner comes at the expense of the tenant!

Unit-based subsidies are very popular with owners who have units with a low market value -- units that are not as good as a tenant could get in the market with a comparable tenant-based subsidy. (This applies to both for-profit and not-for-profit property owners and developers.) Owners with better units have no trouble renting to tenants with tenant-based subsidies or to other tenants. They will not agree to unit-based subsidies, unless paid an extra premium to make the transaction attractive.

The funding history of tenant-based and unit-based housing subsidies strongly supports the theoretical argument that tenant-based subsidies are far more cost-effective. Appropriations for tenant-based programs like Section 8 finders-keepers Existing Housing Certificates assist many, many more households per dollar than the unit-based programs.

There is controversy as to whether or not tenant-based subsidies can meet all of the necessary circumstances requiring housing subsidy assistance. If tenant-based subsidies can meet the impending crisis which the Sub-Committee is addressing, that should be the answer because it will best use the funds available. We must look at the different kinds of circumstances involved to see if and how tenant-based subsidies can do the job.

All of the circumstances in which lower-income housing units will be taken off the market can be subdivided into three categories for the purpose of this analysis. First, there will be tenant-based subsidies coming to an end. The unit-based subsidies which will also be ending can be further subdivided into those units of higher market value (above the HUD published "Fair Market Rents" for tenant-based Section 8 certificates) and units of lower market value (units with market rents at or below the HUD Section 8 Existing Housing Certificate FMR).

CLASSES OF LOWER INCOME HOUSING UNITS TERMINATING

1. Units with tenant-based subsidies. Tenant-based subsidies coming to an end should clearly be replaced by new tenant-based subsidies.

It would be useful also to reduce the administrative overhead and bureaucratic practices of the Section 8 Existing Housing Program. A new program could have more local flexibility and allow more use of production subsidies compatible with tenant-based rent assistance, like the Rental Rehabilitation Program, to assure a sufficient supply of housing for families assisted with tenant-based help.

2. Lower valued units with unit-based subsidies. As these unit-based subsidy projects come to an end of their funding, the owners should be left on their own without further public help while all the tenants should be given tenant-based subsidies.

The tenants will be able to continue living in the same units which (by definition) are affordable to tenants with tenant-based subsidies. The tenants must be free to move if they can find better housing (i.e., better value) for the Federal dollar elsewhere in the market.

Owners of buildings with units good enough to compete for tenants with tenant-based subsidies will have no problem. Owners with worse buildings will have a problem -- but, there is no Federal responsibility to bail them out or any policy rationale for doing so. It would be a great mistake to use the limited Federal funds for housing the poor as a welfare program for building owners!

The point is equally true for not-for-profit owners as it is for profit oriented owners.

3. Higher value units with unit-based subsidies. The answer is the same -- give tenant-based subsidies to the affected tenants -- with one important addition.

By definition, tenant-based subsidies which are limited to the present HUD FMR will not be useable in these higher value units. For some cases that will not be too serious a problem. Other decent affordable units will be available. In many cases, however, there is good public reason to want to keep some or all lower income tenants in the same units -- despite the inevitable consequence of the cost being higher than renting lower valued units.

The solution for that situation is obvious and simple -- allow the local government to pay a rent higher than the HUD FMR when it, the unit of government closest to the problem, determines that higher rents are justified by the circumstances (i.e., the reduction of funds available for other lower income families is warranted).

That judgmental flexibility can easily be given to local agencies when a formula funding approach is used for allocating rental subsidy funds to localities. With a known and fixed amount of funds available to apply to all local needs, the local agency can be trusted to make the trade-off choices between deeper assistance for a smaller number of recipients or more shallow assistance to a larger number.

The local agencies must not be permitted to convert the tenant-based subsidy to a unit-based subsidy. That would only take a benefit away from the tenant and transfer it to the property owner -- a process which the taxpayer cannot afford.

CONCLUSION

If local governments were given a more flexible tenant-based subsidy program (with an ability to use some funds to stimulate housing supply -- of units appropriate for occupancy for families with tenant-based subsidies -- through rehabilitation and new construction) the needs being considered by the Sub-Committee would be met in the best manner possible for whatever level of funding will be available.

The amount of funds will, of course, be a critical factor in the adequacy of the answer, but, for any level, high or low, the greatest possible benefit for low income tenants will be gained by the recommended use of tenant-based subsidy.

Any use of unit-based subsidies will merely detract from the benefit for lower income tenants and shift funds and benefit to the owners and managers of buildings.

The Sub-Committee is urged to resist the pressures from the many, many who will argue that money must be given to "buildings" to help tenants -- money must be made available to tenants to help tenants!

If the Chairman wishes, a specific set of recommendations can be submitted for a flexible, tenant-based, rental subsidy program which would be generally useful as well as meeting the immediate needs which are the subject of this statement.

Thank you again, Mr. Chairman, for the opportunity to present these comments to the Sub-Committee. It is a critical time for examining national housing policy alternatives for lower income families.

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STATEMENT OF THE NATIONAL HOUSING LAW PROJECT BEFORE THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

June 5, 1987

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The following statement is submitted by the National Housing Law Project to the Senate Subcommittee on Housing and Urban Affairs at the request of the Subcommittee Chairman for its hearings concerning the problem of expiring use restrictions for existing multifamily subsidized housing.

Since 1968, the National Housing Law Project has been a resource center on housing matters for attorneys and others who represent poor people in all parts of the country. From this experience, we have gained an extensive body of knowledge regarding the housing needs of poor people and the actual operation of the federal housing programs. From that knowledge, we offer the following information and suggestions to the Subcommittee today concerning this critical issue.

I. The Problem: Expiring Use Restrictions

In the 1960s, beginning with the Section 221(d)(3) Below-Market Interest Rate (BMIR) and Section 236 FHA-subsidized multifamily housing programs, the federal government embarked upon an effort to utilize private ownership as a vehicle to provide subsidized multifamily housing for lower-income families. The subsidy mechanism chosen to accomplish this purpose was a federally guaranteed mortgage with a very shallow interest-rate subsidy that enabled housing to be provided at slightly below market rents. In exchange for the shallow subsidy and guaranteed mortgage, the owner executed a regulatory agreement containing certain restrictions upon project operations and rent increases. In this way it was believed that the federal government could provide housing for lower-income families without substantial public investment.

However, while Congress made the shallow subsidies and mortgage guarantees available for the full mortgage term (usually 40 years), HUD administratively structured these programs in such a way that many profit-motivated owners could prepay the mortgage and terminate the use restrictions without any HUD approval after the expiration of a 20-year period from the date of the loan. Approximately 200,000 units will reach this point by the early 1990's. Because most of these privately owned multifamily units were developed between 1965 and 1975, particularly during the period between 1970 and 1975, we are quickly approaching the date upon which owners will be able to exercise this unrestricted option. Of course, in most cases, they will do so if prepayment would be financially advantageous. Even HUD estimates that approximately one-half of all private owners who are eligible to prepay will exercise their option to do so, placing at risk a minimum of 150,000 HUD-subsidized units. No doubt this estimate is extremely low because HUD's survey cannot give an accurate picture of market dynamics over the next decade. As long as prepayment works to terminate the projects' use restrictions, the quest for these windfall gains will displace low-income tenants and frustrate the intent of Congress to provide decent and affordable housing for poor people through these programs.

This problem is also critical for privately owned multi-family units subsidized by direct loans from the Farmers Home Administration (FmHA) under the Section 515 Rural Rental Housing program. Almost 200,000 units were constructed under this program prior to 1979, and an additional 160,000 units since that date. Presently, loans for units built prior to 1979 can be prepaid at any time without agency approval, thus terminating the shallow interest-rate subsidy and all accompanying use restrictions. Units with loans approved since 1979 are subject only to the prepayment and use restrictions for a 20-year period. Thus, while the problem for newer projects will arise after 1999, the problem for the majority of FmHA Section 515 units is now upon us.

The risk of losing low-income units is not confined to these mortgage-interest subsidy programs. In 1974, Congress enacted the Section 8 program, which provided, inter alia, project-based subsidies to pay the difference between project market rents and a specified percentage of tenant income. In so doing, Congress recognized that shallow subsidy programs were ineffective and that only deep subsidy mechanisms could meet the needs of lower-income households. Again, the federal government utilized private owners to provide the housing, albeit with a deeper government subsidy. However, even though the government provided Section 8 subsidies for periods of between 20 and 40 years, HUD often structured the subsidy contracts to permit the private owners to review their decision to participate at five-year intervals. Many such owners are taking the opportunity on their five-year anniversary dates to "opt out" of the program because they can realize higher returns through non-lower-income use.

Taken together, these administrative design deficiencies have created a significant risk to about one million lower-income tenants. Hundreds of thousands of FmHA units are presently eligible for mortgage prepayment and hundreds of thousands of FHA-subsidized units will be eligible within the next decade. Thousands more will be lost to lower-income use when owners opt out of the Section 8 program. Low-income families and elderly tenants will inevitably be displaced by the resulting rent increases.

II. Causes of the Problem

In order to design effective remedies, Congress must carefully consider the numerous factors which jointly operate to imminently jeopardize the stock of low-income housing.

A. Program Structure

1. Subsidized Mortgage Insurance Programs

The primary reason that units may be lost to the lower-income stock results from the structure of the programs. First, they utilize private ownership. Landlords operating for a profit can hardly be expected to pursue social goals when it is not required or in their economic interest to do so. Even though subsidies were provided for the full mortgage term, HUD only imposed use restrictions for limited periods of time. This was an administrative decision not required by the authorizing statutes. *Compare*, *e.g.*, 12 U.S.C. § 1715z-1 (West Supp. 1985) *with* 24 C.F.R. § 236.30 (1985). Similarly, when opening the subsidized Section 515 program to private, profit-motivated owners in 1973 where FmHA financing was demonstrated necessary to serve lower-income families, FmHA imposed no significant restriction on owners' ability to prepay the mortgages and terminate the use restrictions. In response to legislation, FmHA did so in 1979, but only for loans approved after December 21, 1979. *See* 7 C.F.R. § 1965.90 (1985). While the use restrictions remain in place as long as the mortgage and regulatory agreement do, after a specific period of time those restrictions can be terminated by a prepayment of the mortgage without HUD or FmHA approval. Hence, it is the prepayment restriction that effectively controls the use restrictions.

The prepayment restrictions are as follows:

	Project Characteristics	Restriction
1.	FHA-subsidized projects currently owned by nonprofit owners.	HUD approval, for the full mortgage term (usually 40 years).
2.	FHA-subsidized projects purchased from the original nonprofit owner (usually bought by a limited-dividend or for-profit owner).	HUD approval, for the full mortgage term.
3.	FHA-subsidized or FHA-insured projects currently receiving Rent Supplements.	HUD approval, for the full mortgage term.

4.	FHA-subsidized or FHA-insured projects that received Flexible Subsidy funds since December 1979.	Owner must maintain the "low- and moderate-income character" of the project for the full mortgage term.
5.	FHA-subsidized projects owned by limited-dividend owners, which never received Rent Supplements or Flexible Subsidies (since December 1979) and were never owned by nonprofits.	HUD approval, but only for the first 20 years of the mortgage.
6.	FmHA Section 515 projects with loans approved prior to December 21, 1979.	No FmHA approval required.
7.	FmHA Section 515 projects with loans approved after December 21, 1979.	FmHA approval, but usually only for the first 20 years of the mortgage.

See, *e.g.*, 24 C.F.R. §§ 221.524, 236.30, 265.16 (1985) (HUD projects); 7 C.F.R. § 1965.90 (1985) (FmHA projects). When HUD approval is required for prepayment, the agency must determine that there is no need for the project or that the need can be more efficiently and effectively met through other federal programs. 12 U.S.C. § 1715z-15 (West Supp. 1985). To our knowledge, HUD has not approved more than a handful of prepayments. A similar "no need" determination governs FmHA approvals. 7 C.F.R. § 1965.90 (1985).

When the mortgage can be prepaid without HUD's approval, *i.e.*, after 20 years for projects in category No. 5, or without FmHA's approval, *i.e.*, at any time for projects with pre-December 21, 1979, loans or after 20 years for projects with later loans, the risk is obvious. Whether the risk will become a reality for any particular project will depend primarily upon the project's unrestricted value.

2. Section 8 Projects

a. In General

With respect to Section 8 projects, a significant part of the problem is traceable to administrative actions on the part of HUD rather than inherent statutory deficiencies. HUD's creation of opportunities for owners to "opt out" of the Section 8 program, when combined with the means chosen by the agency to adjust the contract rents paid to owners under the program, is the basic source of the problem. Anytime that an owner can obtain higher rents on the private market than under the Section 8 program and the owner has an opportunity to opt out of that program, the owner will naturally do so.

The Section 8 "opt-out" problem generally only threatens projects that are owned by for-profit sponsors. Since nonprofit owners are not motivated by profit maximization and do not make their decisions based upon financial gains from inflating real estate, they will generally renew subsidy contracts as long as sufficient funds are provided to operate the project successfully as lower-income housing. The one lesson that we must learn from this entire crisis is that nonprofits and public agencies are the most cost-effective vehicles for providing lower-income housing over the long run and that, if for-profit entities are to be involved, the use of the property must be restricted for a very long period of time or a subsidy program must provide total returns that are comparable to those obtainable on the private market. This is a simple lesson, but it is easily forgotten by policy makers and various interest groups advocating for their particular financial self-interest.

b. Availability of "Opt-out" Opportunities

Whether a particular Section 8 project faces an opt-out opportunity is determined by the type of project-based Section 8 program involved and the date its Section 8 contract was executed. Section 8 New Construction and Substantial Rehabilitation projects executed prior to 1980 (usually for a minimum 20-year term) contain an opt-out feature allowing the owner to terminate participation in the program at five-year intervals. Since 1980, these contracts have been written for full terms (minimum of 20 years), without an opt-out feature. In contrast, all project-based contracts executed under the Section 8 Additional Assistance (Loan Management) program present an opt-out problem because those executed prior to fiscal year 1983 were written for a maximum term of 15 years with the opportunity for the owner to "opt out" at five-year intervals, or, since fiscal year 1983, were written for only a five-year term.

c. Available Contract Rent Under the Section 8 Program

(1) Initial Contract Rents

For all of the project-based Section 8 programs, initial contract rents must generally be less than the HUD-approved fair market rents for the program. For new construction, they are largely determined by a cost certification process. 24 C.F.R. § 880.204(b). For Section 8 Loan Management projects, the contract rent is identical to the basic rent (e.g., in a Section 236 project) or a comparable market rent (e.g., in an unsubsidized project). 24 C.F.R. § 886.110.

(2) Contract Rent Adjustments

Under all of the project-based Section 8 programs, the initial contract rents are adjusted annually upon owner request, theoretically by an annual adjustment factor (AAF) that reflects changes in private-market rents. See 24 C.F.R. §§ 888.201 et seq. While the Section 8 statute requires that, after adjustment, rents for Section 8 units should not differ materially from those for comparable unassisted units, 42 U.S.C. § 1437f(c)(2)(C), HUD has engrafted onto this statute a further regulatory limitation for new construction and substantial rehabilitation that allows an exception for differences that existed between a project's contract rents and market rents when the contract was first executed. See, e.g., 24 C.F.R. § 880.609(c). (Strangely enough, this exception does not exist for Loan Management contracts, where a literal reading of the regulation tracks the statute and would require post-adjustment contract rents to reflect the actual market. See 24 C.F.R. § 886.112(d).) This comparability limitation has been inconsistently applied by HUD in various field offices to limit annual adjustments, a practice which is the subject of current litigation. See National Leased Housing Association v. United States of America, No. 6-87 C (U.S. Claims Ct. filed Jan. 9, 1987).

In 1981, Congress revised the language of the Section 8 statute to permit HUD to limit rent adjustments to increases in operating costs, rather than to reflect market rents as a whole, for only the Section 8 New Construction and Substantial Rehabilitation programs. Pub. L. No. 97-35, § 322, codified at 42 U.S.C. § 1437f(c)(2)(D). It is unclear whether this authorization is being applied at all. If it is, it is being applied only to project-based Section 8 New Construction and Substantial Rehabilitation contracts executed after October of 1981 (the effective date of the statute). The resulting reduced annual rent adjustments will not produce opt-out opportunities because, as reviewed above, all New Construction and Substantial Rehabilitation contracts executed after that date do not contain an opt-out feature. (HUD had once proposed to apply the methodology to all New Construction/ Substantial Rehabilitation contracts, but dropped the idea under pressure.) While HUD does not apply this operating cost/AAF methodology to any Loan Management contracts, these projects are nonetheless subject to eventual opt-out pressure because most of these contracts are tied to subsidized projects with HUD operating cost rent control that may be terminated at some point by prepayment.

d. General Summary

For New Construction and Substantial Rehabilitation projects executed prior to 1980, an owner will invariably opt out at the five-year opportunity where market rents exceed the contract rents available under the Section 8 program.

For Section 8 Loan Management projects, predictions are more complicated. Owners of Loan Management projects that are financed with HUD-insured mortgages carrying a HUD rent control requirement (*e.g.*, Section 236) have less incentive to "opt out" when the opportunity is available so long as the HUD rent control remains in place. That is, eliminating the Section 8 contract will not, alone, allow owners to charge market rents, since they can only charge the HUD-regulated rent level. However, to the extent that these projects are nearing the end of their 20-year restricted prepayment period, or have passed that date, the opt-out risk is significantly increased because a simple prepayment would eliminate the HUD rent control and allow the owner who opts out to obtain market-level rents.

Section 8 Loan Management contracts that are not tied to a project with HUD rent control (*e.g.*, unsubsidized projects) simply face the identical situation as any other Section 8 New Construction project evaluating an opt-out opportunity. If the market will deliver a higher rent than the adjusted Section 8 contract rent, then the owner will opt out of the Section 8 Loan Management program.

There is one category of Section 8 Loan Management contracts that merit special attention. This category consists of those projects whose rents were formerly regulated by HUD but were deregulated in 1983. These projects consist of those assisted under, for example, Sections 207 and 231 of the National Housing Act. In 1983, HUD effectively eliminated its control over rents in these projects. However, the owner of a deregulated project who also has a Section 8 Loan Management contract can take advantage of the rent deregulation *only if* the Section 8 contract is terminated. 24 C.F.R. § 207.19(e)(2)(iii), 51 Fed. Reg. 20,270 (June 4, 1986). If the Section 8 contract is not terminated, HUD's regulations require the owner to continue to receive only the Section 8 contract rent, even though the fully deregulated rent would be much higher. Since the Section 8 contract rents for these projects were limited to a HUD-regulated rent level prior to 1983, they are often much lower than market rents in the project's area. Owners of these projects will invariably choose to terminate their participation in the Section 8 program at the first opt-out opportunity because the market will usually yield a much higher rent than that being paid under the Section 8 contract.

A good example of this latter problem is the Victoria Gardens project in Fremont, California, a 75-unit Section 231 project for the elderly that also had a Section 8 Loan Management contract for all the units. The for-profit owner, in the tenth year of the Section 8 contract, received $444 per unit per month under the Section 8 contract. This is the amount of the HUD-approved rent under the Section 231 program. Since rents under the Section 231 program were deregulated in 1983, and equivalent market rents for these units now range between $500 and $550 (the Section 8 Existing Housing Fair Market Rent is at least $549), and the owner cannot charge this deregulated rent unless the Section 8 contract is terminated, the obvious result is that the owner will terminate the Section 8 contract. This the owner has done.

HUD's "solution" to this problem is to provide the tenants with either Section 8 vouchers or Section 8 certificates, which they can attempt to use either at the project or elsewhere in the community. In the case of Victoria Gardens, HUD has recognized that vouchers would not be a suitable replacement subsidy for 75 elderly tenants searching for housing in the tight and inflating Fremont housing market. HUD has therefore committed to providing tenants with Section 8 certificates (which, if usable, carry guaranteed affordability) that can be used at the project so long as the owner agrees to the reasonable rent levels set by the PHA under the Section 8 certificate program. This the owner has agreed to do (at $525). After community and Congressional pressure, HUD, recognizing the danger of displacement posed to the elderly low-income population, finally agreed to require the owner to execute a five-year lease for each tenant. So, what we have as a "solution" is the functional equivalent of a Section 8 Loan Management contract extension, although without the name, because HUD does not want to give project owners the impression that they can get comparable market rent adjustments under the Section 8 Loan Management program upon the owner's threat to opt out.

This result is totally irrational since the replacement subsidies that HUD would provide in any case, either Section 8 vouchers or certificates, will result in the expenditure of funds equivalent to those required to properly adjust the project-based Section 8 Loan Management contract rents to a current market level sufficient to encourage the owner to remain in the program. In fact, in some situations, renewing the Section 8 Loan Management contract and adjusting the rent could sometimes cost less than HUD's preferred portable subsidies. HUD's refusal to properly adjust these Section 8 Loan Management rents for deregulated projects is therefore both illogical and fiscally irresponsible, particularly when that is the only approach that is certain to minimize the displacement of tenants.

B. Value of the Project

Whether or not an owner will exercise the option to prepay the loan after the restricted use period or opt out of the Section 8 contract will depend upon the economic situation of the project and the neighborhood. If the owner can achieve a higher return by charging rents beyond those permitted under the regulatory agreement or by converting the property to cooperative or condominium use, there will be a definite incentive to prepay the HUD or FmHA mortgage or to opt out of the Section 8 contract and eliminate the rent and use restrictions. Local condominium conversion restrictions may occasionally restrict the latter of these opportunities, but the market opportunity to charge higher rents will almost always exist, providing the driving force behind prepayment or opt-out. Owners who can obtain refinancing to permit a prepayment of the original loan will do so. Of course, projects located in neighborhoods that have been "revitalized" will face extraordinary economic pressures for higher rents or conversion to non-lower-income rental use, beyond those normally incident to the escalation of property values commensurate with inflation.

C. The Decline of Tax Incentives

Many of the privately owned projects constructed in the early 1970s are reaching a point in their lives called "tax-shelter burnout" where owners are seeking to sell units that are generating taxable income without cash to pay the taxes. In addition, other projects resyndicated under the generous depreciation provisions of 1981 tax law were structured with short-term seller take-back financing, again, primarily for purposes of enhancing the tax-shelter benefits available to investors. When those loans become due, additional pressures will push toward property sales. Finally, the drastic reduction of tax-shelter benefits for lower-income housing under the 1986 tax-reform legislation has removed most of the indirect federal subsidies that have permitted continued low-income use for existing properties, forcing some owners to look solely to a property's economic value, which again will provide additional pressure to convert to non-lower-income use. This latter factor will prove particularly significant for FmHA projects that require no agency approval for prepayment, as well as those FHA-subsidized projects nearing the end of their restricted payment period.

D. Lack of Creative Administrative Initiative

In addition to the problems inherent in the structure of these programs, there have been numerous instances in which HUD or FmHA could have extended low-income use restrictions but did not take advantage of the opportunity to do so. This passivity stems primarily from the administration's stated intention to remove the federal government from any involvement in the provision of low-income housing. There are many instances where project owners have requested favorable financial consideration from HUD or FmHA, including workouts and mortgage modifications for HUD-held mortgages, additional subsidies such as Flexible Subsidy, Section 8 Additional Assistance or FmHA Rental Assistance, and approval of a particular sale proposal and assumption of the mortgage by the new owner (transfer of physical assets ("TPAs")). Only in the case of providing Flexible Subsidies has HUD imposed continued use restrictions (of a somewhat ambiguous nature) for the entire remaining term of the project mortgage. Thousands of other units that could have been saved by extracting a quid pro quo from the project owner for favorable agency action have gone unprotected.

E. Affirmative HUD and FmHA Actions

In some cases, HUD has deliberately moved or negligently acted to jeopardize continued low-income use. Prominent among this category are (1) the agency's failure to require full utilization of all units subsidized under Section 8 contracts; (2) the agency's deliberate failure to fully utilize the Multifamily Mortgage Foreclosure Act, which imposes use restrictions following foreclosure; (3) its mortgage sale policies, which have permitted HUD-held mortgages to be sold without ensuring that existing use restrictions are ultimately enforceable; and (4) its implementation of the process of converting Rent Supplement projects to Section 8 assistance, where HUD has not yet clearly stated that owners will continue to be bound by the 40-year prepayment restriction that accompanied the original Rent Supplement assistance. No doubt there are other actions falling into this category.

Similarly, FmHA has failed to require full utilization of its deep-subsidy contracts (Rental Assistance and Section 8). Also, FmHA has administrative refinancing restrictions that operate to encourage owners to prepay their loans and terminate the use restrictions (without any agency approval requirement) rather than refinancing their loans in a fashion that would permit continued low-income use.

F. Deregulation of Insured Projects

In 1983, HUD deregulated the rents on projects insured under the Section 220 and 221(d)(4) programs, and effectively did so for other unsubsidized mortgage insurance programs as well. Aside from the obvious effects of unchecked rent increases, units in these projects that were subsidized under a Section 8 contract will be placed in greater jeopardy for continued lower-income use because owners facing a decision whether to opt out of the Section 8 program will be comparing the Section 8 rents to rents on the unregulated private market, rather than to the previously regulated rents of other project units.

The effects of all of these factors will extend far beyond simply encouraging certain owners to prepay their mortgages and terminate the use restrictions, including the requirements for agency approval of rent increases and evictions only for good cause. In addition, in some cases, prepayment and termination of use restrictions will promote the drift toward poor maintenance and management (because of the lack of agency supervision), even with the simultaneous rent increases. Even if loans are not prepaid and use restrictions remain, the withdrawal of indirect tax subsidies from low-income housing, if not replaced by targeted direct subsidies, will promote the under-maintenance and poor management of these units, placing an increasing number of units in default for eventual processing through foreclosure and, perhaps, the Property Disposition program. HUD was given some breathing room by the tax subsidies in the 1981 tax law that are now being withdrawn, and the scope of the troubled projects problem can now be expected to widen considerably. Without adequate subsidy, active and competent agency oversight, and good management, use of these units by lower-income people will also be seriously threatened.

III. Suggested Strategies

The enormous magnitude of this problem demands extraordinary action. Only upon insistent prodding by Congress has HUD taken any action to investigate the magnitude of this problem. HUD's current approach consists of gathering information, providing vouchers to displaced families, and telling local governments to deal with the problem. No one will disagree that accurate information will be useful in moving toward solutions. However, HUD well knows that imploring local governments to utilize already oversubscribed CDBG funds is nothing but a rhetorical solution. HUD's other remedy -- providing vouchers to eligible tenants -- while certainly more than rhetorical, is not a responsible federal policy.

HUD and Congress must realize that it is precisely in these markets where prepayments and "opt-outs" will be occurring because of booming real estate markets that vouchers will not guarantee affordable replacement housing for displaced families. First of all, one of the inherent problems in the voucher program is its inability to provide housing on a non-discriminatory basis. Voucher holders who are non-white, large families or single parents with children will continue to be victims of private market bias. Elderly households face the trauma, if not the impossibility, of relocating from apartments that they considered as their final home. These difficulties will be exacerbated in communities with hot markets and low vacancy rates, which are the very communities where these attempted conversions will usually occur. In addition, because of the structure of the voucher program, which presently provides an affordability adjustment in the payment standard only on a discretionary basis and only twice in every five years, tenants will quickly end up paying more than the federal affordability standard, i.e., 30 percent of their income, for rent. This is not just speculation, but has been confirmed by several studies examining the operation of the voucher program in particular housing markets. Tenants in these markets commonly have to pay between 35 and 60 percent of their incomes for rent in order to find housing which will permit them to utilize their voucher.

Finally, using vouchers as replacement housing does not constitute a rational replacement housing policy because, over the long run, vouchers will be just as expensive, if not more expensive, than project-based subsidies. This is because vouchers, if they are to be truly affordable, must provide subsidies to tenants to cover the difference between a federal affordability standard (30 percent of adjusted income) and the cost of obtaining decent housing in the community, i.e., a comparable market rent. This cost is identical to that which would have to be provided to a profit-motivated private project owner in order to encourage participation in a low-income housing program. Vouchers look cheaper only because HUD has only sought fund commitments for a five-year period. Vouchers would also be cheaper if, because of the program structure, tenants are forced to pay more than 30 percent of their income for rent and thus the federal subsidy is reduced. We submit that Congress should not sanction this smoke and mirrors game as a rational replacement housing policy.

One thing we have learned over the last 20 years is that the most cost-effective housing policy is one that utilizes public and nonprofit ownership, where rents are not based upon what the private market will command in a particular community. The per-unit subsidy cost of housing programs utilizing nonprofit and public ownership is far less expensive over the long run than relying on the market. It is the only way to ensure that the public does not have to pay the cost of subsidizing a private owner's equity appreciation. It instead ensures that rents and subsidies are based only on the cost of providing decent housing, rather than the rents that asset can command. In addition, the advantage of utilizing this mechanism to provide housing assures long-term availability and community integration since nonprofits have no incentive to trade these resources for windfall gains.

If we fail to learn this most basic of all housing lessons, we will continue to create crises of the magnitude that we now face, at enormous unnecessary cost to increasingly scarce federal financial resources.

A. Prepayments -- Legislative Remedies

To address this problem, there are many administrative mechanisms HUD could utilize that do not require additional statutory authorization. Congress must direct HUD to do so. In addition, Congress must direct HUD to cease certain of its activities that exacerbate the problem.

Finally, there are a number of steps Congress could take through legislation. Repeatedly raised by owner interest groups is the claim that Congressional actions to preserve units would be unconstitutional under either the takings, impairment of contract, or due process clauses. These claims are spurious in most circumstances and whether they are correct in the remaining cases is such a close question that only a court will be able to decide them. Because any ultimate judicial decision about the legality of specific remedial measures must depend upon the specifics of the measure and the reasons for its enactment, definitive statements in this area are practically useless. Therefore, the choices faced by Congress here are not so much questions of legality, but rather those of political will.

1. Moratorium. First, while information is being gathered by Congress and interested parties, Congress should declare a moratorium on the prepayment of any HUD-subsidized loan, just as Congress did for FmHA loans last year. Given the complexity of the issue, there is no doubt that it will take time to craft a range of appropriate legislative and administrative solutions to this problem. During that time, there is no reason to lose a single unit from the stock, and a moratorium would prevent that from happening. The moratorium would have the added advantage of focusing legislative activity on a specific date. The moratorium should be at least one year in length.

As longer-term solutions, Congress should do the following:

2. Continued regulation. Congress should pass legislation stating that prepayment of the loan for any existing project does not terminate a project's rent and use restrictions and existing subsidy, which remain effective for the full mortgage term. This is the best remedy because it squarely cures the original administrative design problem of these programs. Alternatively, Congress should pass legislation imposing continued rent regulation upon any project that is prepaid. Either of these approaches would accomplish a similar result, though the

rent regulation in the latter approach could be different from the existing restrictions.

3. Windfall profits tax or capital gains tax relief. Congress should pass legislation taxing any profits made by owners as a result of prepayment and termination of use restrictions. These taxes could be levied on either the post-termination rental income or on the capital gains resulting from a post-termination sale of the project. The tax revenues could be used for a replacement housing subsidy fund. Alternatively, Congress should pass legislation forgiving some or all of the capital gains tax on sale of a project so long as the project is sold to a nonprofit organization or public agency for continued lower-income use.

4. Preemptive option to nonprofits and public agencies. Congress should pass legislation giving public agencies, tenant organizations and nonprofit groups the right to purchase projects facing prepayment at fair market value. In order to give effect to this preemptive option, financing will have to be provided by local governments or federal grant or loan funds will have to be appropriated by Congress to underwrite these capital expenses. Experience has demonstrated that, over the long run, this will be the most cost-effective way to provide decent and affordable housing for lower-income people. This approach will ensure that these units remain available for lower-income use on a long-term basis. H.R. 4, § 206, recognizes the necessity of a preemptive option and bridge financing for FmHA projects.

5. Continued regulation with additional subsidies. Congress should pass legislation providing expanded subsidies to owners seeking to prepay their mortgages without agency approval and extend the use restrictions. Current law only gives such owners a priority for already scarce Flexible Subsidy and Section 8 Additional Assistance, if these funds would prevent the prepayment. 12 U.S.C. § 1715z-15(b). The subsidy provided by this approach could either be a limited subsidy (the difference between the current fair market rent for the units and the rent that was in effect prior to the expiration of their restricted prepayment period) or a deep subsidy like Section 8 (the difference between the fair market rent and 30 percent of the tenant's income). Prohibiting prepayments and providing these subsidies would minimize legal challenges. If the subsidy is made available at the option of the owner and prepayment is not prohibited, certainly an inferior remedy, then the mortgage interest subsidy funds recaptured from prepaid loans could fund a portion of this program.

6. Restrict discretionary prepayment approvals. Where HUD approval of prepayment is required, Congress should repeal the language of the current statute (12 U.S.C. § 1715z-15(a)) that allows HUD to permit prepayment where HUD determines that other federal housing assistance might be more "efficient or effective." There should be no justification whatsoever for HUD approving a prepayment, given the magnitude of the low-income housing crisis. H.R. 4, § 161(d), would so amend the law.

7. Replace the units lost. Congress should authorize new subsidies to provide replacement units. These units should be owned only by nonprofit or public sponsors and should be deeply subsidized, like Section 8 or public housing.

8. Capital improvement loans. Congress should enact an additional capital improvement loan program for FHA-subsidized projects with continued use restrictions to encourage owners to continue to provide decent and affordable subsidized housing. However, Congress must ensure that any such loans do not result in increased rental burdens on tenants.

9. Targeted preferential tax treatment. If adequate direct capital loans, grants and subsidies are not made available, Congress should provide targeted preferential tax treatment for owners of existing HUD-subsidized housing. In exchange for such preferential treatment, use restrictions must be extended for the full mortgage term.

10. Notice and obligation to negotiate. At the very least, Congress should pass legislation requiring that owners give at least one-year notice of intent to prepay and impose an obligation on them to negotiate in good faith with nonprofit and public agency purchasers. H.R. 4, § 161, provides a step in this direction, though its one-year notice requirement is easily rendered useless by giving owners the ability to perpetually renew it, once given. Without the other statutory steps enumerated above, this step alone will accomplish little.

11. Block mortgage sales. Congress should stop HUD and GNMA from selling mortgages on HUD-subsidized projects which jeopardizes the goal of maintaining the maximum number of units possible. H.R. 4, § 162(f) would do so.

B. Prepayments -- Administrative Remedies

HUD is not doing all that it could to take affirmative steps to stem the loss of units from the subsidized housing stock, primarily because of its stated preference for voucher subsidies. Congress must ensure that HUD does everything within its power to minimize the extent of this problem.

1. Attach restrictions for HUD approvals. Whenever an owner requests favorable HUD action, the agency should extract the *quid pro quo* of extended use restrictions for the full mortgage term. This should apply for HUD approval of any application for HUD Flexible Subsidy funds, capital improvement loans, Section 8 Additional Assistance (Loan Management) subsidies, transfers of physical assets (TPAs), work-outs and mortgage modifications, or any other act where the owner is seeking HUD approval. H.R. 4, § 162(f) would restrict certain TPAs.

2. Rent Supplement restriction. HUD must immediately issue a policy statement to all owners of projects converted from Rent Supplement to Section 8 assistance that they are still bound by the original 40-year prepayment restriction.

3. Flexible Subsidy restriction. HUD must immediately clarify that the use restriction which accompanies Flexible Subsidy funds ("to maintain the low- and moderate-income character of the project for the remaining mortgage term") means either that the owner cannot prepay the loan or that, if prepayment is permitted, the project remains restricted by the terms of the regulatory agreement in effect prior to the prepayment for the full mortgage term.

4. Assignment terminates right to property. HUD should issue a policy statement that assignment of any HUD-subsidized mortgage to HUD by the insured lender operates to terminate the owner's right to prepay.

5. No rent increases. If HUD takes other administrative steps to increase financial incentives to existing owners in order to avoid prepayment (such as increasing cash flow by permitting greater percentage returns on equity or increasing the equity base, allowing servicing of secondary debt, allowing access to reserves, or similar measures), it is imperative that additional subsidies be provided so that the rental burden of low-income tenants is not increased.

C. Section 8 Nonrenewals -- Administrative and Legislative Remedies

1. Provide comparable market rents. Congress has already directed HUD to adjust contract rents in Section 8 projects to a market-comparable level (42 U.S.C. § 1437f(c)(2)(A) and (C)), but HUD has not heeded this mandate. When owners have the opportunity to opt out of the Section 8 program, particularly with pre-1980 Section 8 New Construction and Substantial Rehabilitation projects, HUD must exercise this authority to readjust the contract rents to a comparable market rent. This approach will also help with Section 8 LMSA projects that have been

"deregulated," because it will allow owners the opportunity to achieve the returns that HUD has made available to them through the deregulation. The House bill, H.R. 4, § 142(g), provides only a partial solution to this problem by allowing HUD to adjust rents for projects with contract rents below Section 8 Existing Housing fair market rents up to the Section 8 fair market rent level. While this approach may help with the deregulated projects, it will not assist many of the Section 8 New Construction projects, which probably have slightly higher rents. Congress should address this issue by passing corrective legislation explicitly requiring HUD to annually adjust rents to market comparables.

2. Requiring certain owners to renew. HUD must issue a regulation confirming Congress' intent in adopting the 1978 "non-interference" statute. This law states that subsidized project owners cannot interfere with tenants' efforts to obtain rent subsidies. 12 U.S.C. § 1715z-1b(b)(2). HUD has not clearly stated whether subsidized project owners with Section 8 LMSA contracts are obligated to renew those contracts if they would provide the same rental income as that available under the underlying subsidized program. Since there are no other rental assistance programs available, Congress must have meant that owners are obligated to participate in the program if it is available and would provide them with comparable economic returns. HUD's regulation (24 C.F.R. § 245.205 (1986)) does not specifically address this issue in the non-renewal context. However, HUD's regulation does improperly state that the statute does not require owners to execute contracts under the Section 8 Existing Housing program. While HUD's interpretation of the statute has rendered it totally meaningless, that absurdity should not be carried forth into the Section 8 project-based subsidy program where the owner has already executed a contract. Congress should also address this issue with further clarifying legislation.

3. Blocking deregulation of certain low-income projects. HUD deregulated rents for many programs in 1983 by administrative fiat and thereby created the incentive for many owners to opt out of the Section 8 LMSA program. HUD should rescind these regulations and, if not, Congress should pass legislation explicitly re-regulating these projects which HUD has deregulated. The House bill, H.R. 4, § 330, would block the deregulation of any project that has not been deregulated as of May 1, 1987, where the project either has a majority low-income tenancy or receives Section 8 project-based subsidies.

4. Notice and preemptive option for nonprofits and public agencies. Congress should pass legislation requiring a one-year prior notice and creating a preemptive option on behalf of nonprofits and public agencies, to enable acquisition of projects owned by for-profit owners desiring to opt out of the

Section 8 programs. Again, just as for projects facing prepayment, Congress will also have to provide capital grants or loans for bridge financing to cover the difference between the project's fair market value and the existing debt. H.R. 4, § 142(f), properly requires a one-year notice to HUD and the tenants, with HUD review of the legality of the termination and steps to avoid it.

5. No more "opt-out" contracts. HUD must ensure that future Section 8 contracts are written for the full term authorized by Congress, with no opt-out provision included.

Thank you, Mr. Chairman, for requesting the views of the National Housing Law Project on one of the most critical low-income housing issues facing the nation today and over the next decade.

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STATEMENT OF THE NATIONAL HOUSING LAW PROJECT FOR THE SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS OF THE SENATE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON

THE DECLINING SUPPLY OF RURAL RENTAL HOUSING

June 5, 1987

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The following statement is submitted by the National Housing Law Project to the Senate Subcommittee on Housing and Urban Affairs at the request of the Subcommittee Chairman for its hearings on the declining supply of rental housing for low and moderate income people. This statement will focus in particular on prepayments in rural areas.

Since 1968, the National Housing Law Project (the Project) has been a resource center on housing matters for attorneys and others who represent poor people in all parts of the country. The Project's staff has extensive knowledge regarding the housing needs of poor people and the operation of the Farmers Home Administration (FmHA).

The Project has a particular interest in the subject of today's hearing since, following our unsuccessful effort to prevent the displacement of six elderly tenants from a prepaid Section 515 project in southern Ohio, our staff was instrumental in bringing the FmHA prepayment problem to the attention of Congress in 1979 and in securing, that same year, passage of legislation prohibiting, both prospectively and retroactively, the prepayment of subsidized Section 515 loans. Unfortunately, the retroactive prohibition on prepayment was repealed in 1980 and, as we predicted, prepayments resumed at a faster rate. As a result, we are now afforded this second opportunity to examine what should be done about tenant displacement and the loss of a significant portion of FmHA's rural rental housing stock. We are pleased to revisit the issue and thank the Subcommittee for inviting us to participate in its deliberations.

It is important to examine the rural prepayment problem in a historical context. When this is done it is apparent that part of the problem lies with FmHA's misadministration of the §515 program since the early seventies.

Several sections of the Housing Act of 1949 need to be looked at. The first two sections are § 501(c)(3) and § 502(6)(3), respectively known as the "credit elsewhere" requirements and the "graduation" requirement.

Section 501(c)(3) states that for an applicant to be eligible to receive FmHA's assistance, the applicant must show that "he is unable to secure the credit necessary for such housing and buildings from other resources upon terms and conditions which he could reasonably be expected to fulfill." 42 U.S.C. § 1471(c)(3).

Section 502(b)(3) requires that FmHA include in its loan documents a provision which requires that the borrower at the request of the Secretary "will...proceed with diligence to refinance the balance of the indebtedness through cooperative or other responsible private credit sources whenever the Secretary determines in light of the borrower's circumstances, including his earning capacity and the income from the farm, that he is able to do so upon reasonable terms and conditions." 42 U.S.C. § 1472(b)(2).

Together these two sections operate to ensure that FmHA not compete with private lending institutions. The first section precludes applicants from obtaining FmHA loans if they can obtain credit from private sources, while the second provision requires borrowers to graduate from the FmHA programs if, as a result of FmHA's assistance or otherwise, they become able to refinance the FmHA loans through private commercial sources.

Prior to 1972 only nonprofit organizations and consumer cooperatives were eligible for direct subsidized loans and individuals and partnerships were eligible for insured loans. At that time, the § 515 program was operating as intended and the prepayment provision was of no significance. Borrowers who received subsidized § 515 loans generally could not obtain credit from other sources and had no motivation for selling the project since they were achieving the purpose for which they were organized--providing housing for low-income persons.

Unsubsidized borrowers could only get loans if they met the credit-elsewhere test and could be required to refinance the loans, and concomitantly, had the right to prepay whenever they were able to obtain credit from other sources. Since the loans were unsubsidized, the impact on tenants was negligible because refinancing would not raise rents substantially.

In 1972 however, FmHA by regulation, changed the scheme for the § 515 program by authorizing the making of subsidized § 515 loans to individuals or private corporations committing themselves to operate on a limited profit basis, namely by limiting their return on investment to 6%. 37 Fed. Reg. 18700 (Sept. 15, 1972). This was later changed to 8%.

Since private corporations and individuals could often obtain loans from other sources, FmHA, by regulation, also modified the credit-elsewhere provision, which heretofore parroted the statutory language, to read:

> To be eligible for an RRH loan the applicant must:
>
> (2) Be unable to provide the housing from its own resources and unable to obtain the necessary credit upon terms and conditions that would enable the applicant to rent the units for amounts that are within the payment ability of eligible low and moderate income or senior citizen occupants. [37 Fed. Reg. 18701, Sept. 15, 1972; emphasis added.]

This provision makes programmatic sense as well as reflecting the congressional intent of the § 515 program that the credit-elsewhere test be based on the financial circumstances of the beneficiary, which in the case of § 502 is the borrower/occupant and in the case of § 515 is the tenant.

Interestingly, FmHA did not change the graduation requirement. All regulations with respect to graduation have effectively remained the same. Borrowers continue to execute mortgage instruments by which they agree to refinance their loan whenever FmHA determines that they are able to do so upon reasonable terms and conditions. At the same time, FmHA directs its county supervisors to review on an annual basis the ability of borrowers to repay the FmHA loan through refinancing.

For consistency's sake, if not because the statute logically implies it, one would expect FmHA to condition the graduation requirement in the same manner that it conditioned the credit-elsewhere requirement. The effect would be that FmHA could not require the refinancing of § 515 loans (and borrowers could not prepay) if, as a result of refinancing (or prepayment), the project could no longer serve low- and moderate-income tenants. Unfortunately, FmHA has not taken this step.

The cumulative effect of FmHA's administrative actions was to exempt some sponsors from having to comply with either the credit-elsewhere requirment or the graduation requirement. Not only is this illegal, but it has effectively destroyed the symmetry which Congress carefully built into the program and has victimized those very persons whom the program was intended to assist. Low-income tenants who were previously assured that subsidized projects will remain low- and moderate-income housing continue to be attracted to § 515 housing but stay there at the mercy of the sponsors. They may now be evicted at will whenever it is no longer in the sponsor's interest to maintain the housing as low- and moderate-income housing.

The § 515 program was enacted to enable rural elderly persons "to live out their lives in dignity and surroundings that are essential to their well being and where they will be close to their relatives and life-long friends." S. Rep. No. 2049, 87th Cong. 2nd Sess. (1962). It was intended to assist those who "no longer have the incentive or the capacity for maintaining ownership of their homes." Id. at 2050. How these purposes can be achieved at the same time that § 515 sponsors have the unfettered discretion of prepaying their loan and terminating the low-income status of the projects is beyond comprehension.

The need to enact legislation that would protect residents of FmHA rural rental housing projects from displacement and preserve the existing low-income rural housing stock could hardly be more acute. There are today over 200,000 units of FmHA rural rental housing that are totally free of prepayment restrictions. This represents nearly two-thirds of the entire FmHA-financed rural rental housing stock. Without remedial legislation, we expect that most of this low-income housing will be converted to other uses before 1992. As a result, we expect that tens of thousands of low-income rural residents will be displaced from their homes and that valuable housing, constructed with the expectation that it would serve the needs of low- and moderate-income persons for at term of 30, 40 or even 50 years, will be forever lost after only 10 or 15 years of service.

There are several reasons why we expect prepayments to increase dramatically over the next several years. Primary among them is the expiration of tax shelter benefits from subsidized loans made to limited partnerships and other wealthy investors. The phenomenon is called "tax shelter burnout." It usually occurs 10 to 12 years into the life of a tax shelter and is marked by the fact that by that time a project is generating taxable income but not enough cash with which to pay the taxes. To limit the impact of the "burnout," the project owner sells the project to another investor.

In theory, there is no reason why a new investor cannot maintain the low- and moderate-income nature of a project if financing for the purchase is available, as well as additional subsidies to offset the cost of amortizing the new or subsequent loan. FmHA regulations governing project transfers do not, however, provide for either. In fact, they prohibit the new owner from mortgaging the property to obtain additional financing (7 C.F.R. § 1965.65(b)(3)(ii)(1986)), disallow the use of project rents to pay for any equity payment made to the previous owner (Id., § 1965.65(b)(3)(i)), and limit the new owner's rate of return to that of the old owner. Id., § 1965(c)(9). In short, FmHA regulations discourage the sale of projects to anyone other than an investor who will convert it to other uses.

According to data collected by the Housing Assistance Counci, "tax shelter burnouts" are already a major force behind the prepayment of § 515 loans. In 1979, 1980, 1981 and 1982, the number of prepaid § 515 loans was, respectively, 80, 52, 52, and 53. In 1983, 1984, 1985, and 1986, the respective number of prepayments was 127, 158, 125, and 157. The dramatic rise in prepayments beginning in 1983 is not coincidental. Limited partnerships and other private individuals were not eligible for subsidized § 515 loans until 1973, exactly 10 years before FmHA began to experience a dramatic increase in the number of prepayments.

Given that, between 1973 and 1978, limited partnerships were only eligible to participate in the § 515 loan program on a limited basis, it is likely that the prepayments that have occurred so far are only the beginning of a large wave of prepayments anticipated to crest in 1991 or 1992, when the last projects built without a prepayment restriction reach their burnout stages.

Unfortunately, our prediction is bolstered by the fact that § 515 program reached its peak, in terms of the number of units constructed annually, in the four years preceding the imposition of the prospective restrictions on prepayments. Over 147,000 units of § 515 housing -- more than one-third of the total units constructed under the program since its inception in 1963 -- were constructed between 1977 and 1980.[1] Because a vast majority of these projects are owned by individuals or entities that have depended on the tax losses they generated, one can expect that these projects will be sold and prepaid between 1987 and 1992.

Prepayments are also encouraged by other, more traditional economic considerations. If an owner can achieve a higher return by charging rents beyond those permitted by FmHA or by converting the property to cooperative or condominium use, there is an incentive to prepay the FmHA loan and to eliminate the rent and use restrictions. Obviously, not all FmHA projects are located in areas where the market forces provide incentives to prepay the FmHA loans and convert the projects to other uses. For example, many projects constructed since the early 1980s, when FmHA started to give funding priority to projects that were to be located in smaller and more rural communities, have probably not appreciated substantially. However, a major portion of the FmHA housing stock constructed prior to that time was in communities experiencing rapid urbanization and/or serving as bedroom communities to nearby urban areas. Since the market value of these projects is likely to have increased substantially, there is reason to expect that many, if not most, of them will be prepaid.

It is important to realize that the true scope of the prepayment problem is not readily apparent from a mere examination of the number of past prepaid loans. Prior to 1975, FmHA did not finance projects costing more than $750,000.

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[1] Because FmHA applied the prospective prepayment prohibition to projects approved after December 21, 1979, it is our belief that most of the loans that were closed during the calendar year 1980 are exempt from the restriction.

Consequently, most FmHA projects constructed prior to that time did not contain more than 15 or 20 units each. For several years thereafter, an administratively imposed loan limit of $1 million limited projects to no more than 30 or 40 units. It was not until the late 1970s that FmHA lifted its loan limitations and authorized the construction of projects containing 100 or more units.

As newer and larger project loans are being prepaid, the number of units converted -- and tenants displaced -- is increasing at a substantially greater rate than the number of prepaid loans. The data collected by the California Department of Housing and Community Development dramatically demonstrates this point. It shows that the five FmHA loans prepaid in California in 1977 financed a total of 53 units, or fewer than 11 units per project. In 1984 (the next year in which more than one FmHA loan was prepaid), however, FmHA had seven loans prepaid in the state and the average number of units per project was 25. By 1985, the number of prepaid loans increased to eight and the average number of units prepaid per project increased to 32. Finally, in 1986, there were 10 prepaid loans, with an average of 60 units per project. Thus, even though, between 1977 and 1986, the number of prepaid loans only doubled, the number of units converted increased tenfold.

Allowing the loss of units to continue at this exponential rate can only result in massive displacement, homelessness, and an intolerable waste of valuable federal resources. Consequently, we urge you to put an immediate stop to these conversions by enacting a better solution than is found in H.R. 4.

The rural prepayment provisions in H.R. 4 are wholly inadequate as a comprehensive solution to the problem it attempts to address. The main problem with the apporoach in H.R. 4 is that it does not preclude prepayment, and consequently the loss of low-income housing units as a resource for the poor in rural communities. For example, by allowing prepayment 20 years from the date of the loan origination, H.R. 4 only postpones the prepayment problem. The bill would also permit owners to prepay the loan, ostensibly maintain its present use for the years remaining in the 20 year period and then convert its use to other than low-income housing.

H.R. 4 also permits prepayment in cases where there are available units for the tenants within a 25 mile radius of the project. It is unconscionable to require an old person or a poor family to move 25 miles to seek shelter just because an owner no longer desires to provide low-income housing.

Finally, H.R. 4 only sets out to preserve 5,000 units of housing a year. We are quite certain that over 100,000 units will be prepaid within the next five years unless there is remedial action.

We therefore urge the Subcommittee to adopt its own proposal, one that would address the issue head on: to preserve the housing that was built for low-income and elderly rural households as the national resource that it is. To do this it is essential that as the private sector abandons the stock or seeks to convert it to other uses, or seeks to get out from under the governmental use restrictions, that the housing be put in the hands of the publc or nonprofit entities whose goal is to maintain it as low-income housing. The seeds of such a program were in H.R. 1070 and with some improving amendments could have achieved the desired result. Unfortunately the monied interests won the day and the result is of little value to most poor and elderly in need of decent affordable rural rental housing.

The program should require that whenever any owner of a § 515 project that is eligible for prepayment offers to prepay such loan, that the project be offered for sale to qualified public and nonprofit entities at the fair market value and that FmHA finance the difference between the fair market value and the outstanding indebtedness of the project. These entities should be provided with financial assistance to enable them to effect the transfer and to protect current tenants from rent increases caused by increased debt. The details of such a program easily suggest themselves as long as the fundamental concept is maintained.

The beauty of such a program is that it is many times less expensive to maintain the housing stock in this fashion than it is to replace it with new housing or to deal with a larger homeless population. The program is not only less expensive but protects the statutory interests of the tenants while at the same time protecting the constitutional rights of the owners.

If the Subcommittee does not have the time now to work toward this solution, an extension of the existing moratorium on prepayments is in order. There can be little doubt that there are a number of greedy and dispassionate owners standing at FmHA's door with prepayment offers in hand, hoping to convert their projects the day the moratorium is lifted. How can the Congress say to the tenants that will be displaced "that we looked at the problem you face but are unable to think of a solution?"

Before concluding our remarks, we would like to bring to the Subcommittee's attention several concerns that we have with FmHA's administration of the existing prepayment restrictions. The first involves FmHA's implementation of the 1979 legislation precluding prepayment of any loans made after December 21, 1979, for a term of 15 years if unsubsidized or 20 years if subsidized. The relevant part of that legislation provides that "[t]he Secretary may not accept an offer to prepay, or request refinancing . . . of any loan made or insured under Section 1484 or 1485 of this title pursuant to a contract entered into after December 21, 1979." 42 U.S.C. § 1472(c) (West 1976) (emphasis added).

The clear intent of Congress notwithstanding, FmHA, in its implementing regulations, only applied the prepayment prohibition to projects approved after December 21, 1979. 7 C.F.R. § 1965.90(B)(1986). In other words, FmHA exempted from prepayment all projects it had approved, preliminarily or otherwise, before December 21, 1979, even though it did not actually enter into a loan contract for those projects until after that date. FmHA's decision effectively exempted from use restrictions practically the entire pipeline of loans pending as of December 21, 1979.

We estimate that this action illegally exempted over 40,000 units of § 515 housing from the 15- and 20-year prohibition on prepayment and that the failure to remedy this action will hasten the need to refinance these units.

We urge that the Subcommittee remedy this illegal action by requiring FmHA to amend its regulations and its contracts to conform the mandate of the 1979 legislation or, in the alternative, by enacting remedial legislation that would preclude project owners whose loan contracts were signed after December 21, 1979, from prepaying their loans except in accordance with the provisions of 42 U.S.C. § 1472(c)(1).

We are also concerned about FmHA's administration of the moratorium on prepayments. In response to the moratorium legislation, FmHA directed its staff to accept the prepayment of loans for pre-1979 projects that are less than 20 years old on the date of the proposed prepayment, if a determination is made by the state director that a supply of adequate comparable housing is available in the community or prepayment will not result in a substantial increase in rents to tenants in residence upon the date of the prepayment or to tenants who are subsequently displaced. FmHA AN No. 1483 (1965) (Oct. 21, 1986). Unfortunately, FmHA did not direct its offices on how they were to determine whether the prepayment would, or would not, result in a substantial increase in rents to the tenants in residence. As a consequence, we are aware of several instances where owners of § 515 projects with Section 8 subsidy assistance have had their offer of prepayment approved because FmHA assumed that tenant rents would remain unchanged due to the continuance of the Section 8 subsidy.

In fact, such an assumption may be misplaced. Owners of Section 8 projects have the unilateral right, at five-year intervals, to "opt out" of the Section 8 contract. Thus, absent some contractual agreement, FmHA has no assurance, as is required by the moratorium statute, that the tenants in residence on the date of prepayment will not be displaced shortly after the prepayment as a result of the owner choosing to "opt out" of the Section 8 contract at the expiration of the next five-year interval.

In our opinion, prepayment offers by owners of Section 515/8 projects should not be accepted during the moratorium period unless they are accompanied by a written agreement with the owner, enforceable by FmHA or the tenants, that the owner will not "opt out" of the Section 8 contract until the expiration of its full 20-year term. We urge the Subcommittee, through its oversight functions, to impress upon FmHA not to accept any further Section 8 prepayments unless it also protects the tenants in those projects by the means which we have described.

We understand that FmHA has agreed to revise its regulations governing prepayments. In particular, we understand that the agency proposes (1) to increase to six months the notice that a landlord is required to give to FmHA and to tenants of a proposed prepayment, (2) to extend to 60 days the period of time during which a person may exercise the right to obtain an admissions priority to another FmHA project in the area, (3) to transfer unexpired Rental Assistance authority from the prepaid project to other projects in the area where tenants are likely to relocate, (4) to require owners to provide tenants in § 515 projects with one-year leases, and (5) to enumerate more clearly the loan servicing actions that would cause projects without prepayment restrictions to become subject to such restrictions.

While most of these proposals are welcome, we wonder why the agency is limiting the rights of displaced tenants to gain priority admission to other projects by restricting that priority to projects located in the same service area as the prepaid project, by limiting to six months the period of time that a displaced tenant may obtain a letter of admission priority, and by requiring that the tenants exercise their letters of priority within 60 days.

It seems to us that a displaced tenant's right to an admissions priority should not be arbitrarily restricted. As long as the tenant has not relocated into affordable, decent, safe and sanitary housing, the tenant should be given priority admission to any project financed by FmHA or, for that matter, by HUD. We urge the Subcommittee to use its influence in this matter to gain FmHA's acceptance of these changes.

We thank you again for the opportunity to submit this statement.

STATEMENT OF EMILY P. ACHTENBERG
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before the

SENATE SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS

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INTRODUCTION & BACKGROUND

The following statement is submitted at the request of the Senate Subcommittee on Housing and Urban Affairs concerning the problem of expiring use restrictions and subsidy commitments in the privately-owned, federally-assisted housing stock.

For the past fifteen years, I have worked with community-based non-profit organizations and government agencies in Massachusetts to preserve formerly-subsidized housing units in HUD's foreclosure and property disposition pipeline--the projects that have failed. I have co-directed a local Demonstration Project to explore alternative strategies for this inventory, assisted a city-state Task-Force in marshalling local resources to facilitate constructive disposition solutions, and provided consultant services to several tenant and non-profit groups who have successfully converted foreclosed projects to cooperative or community-based ownership.

Now it is ironic, to say the least, to find ourselves confronted with the potential loss of subsidized projects that are at risk because they have succeeded. However, some of the lessons learned from our local experience with the distressed HUD inventory may be useful in guiding our approach to the expiring use restriction and subsidy contract problem as well.

In Massachusetts, where the shortage of affordable housing has truly reached crisis proportions, the expiring use and subsidy contract problem is rapidly emerging as one of the major public policy issues of the 1980s. At risk are some 18,000 units in 105 low and moderate income developments with mortgages insured under the Section 221d3 below-market interest rate (BMIR) or Section 236 programs, which will become eligible for prepayment by the Year 2000. Approximately one-half of these mortgages will be eligible for prepayment by the the middle of 1993, creating the potential for termination of all future use and regulatory restrictions for over 9000 units in just seven years.

To compound this problem, half of these immediately at-risk projects receive additional assistance in the form of Section 8 Loan Management Set-Aside (LMSA) contracts, which have permitted them to serve very low income families. These subsidy contracts are funded for 15 years, but include an "opt-out" feature which permits non-renewal by the owner at 5-year intervals. In any case, most of these contracts will expire in the early 1990s, at just about the point when the project mortgages can be prepaid.

Under these regulatory circumstances, there is a risk that substantial numbers of units will be lost from the HUD-assisted inventory in the coming years, for a variety of reasons. First, with Massachusetts' booming economy and real estate market, many older developments are located in areas where there is now strong demand for condominiums and market-rate rental housing. A typical unit in a reasonably well-managed, well-situated subsidized project built 20 years ago for $15,000 might now have an outstanding mortgage debt of $8,000 and be worth $75,000 as a condominium, creating an opportunity for developers to cash in on substantial residuals.

From a tax standpoint, the same project has likely become a liability to investors who are now required to pay taxes on "phantom" income exceeding the cash flow actually generated. Alternatively, in recently resyndicated projects, investors are confronting a substantial reduction of tax benefits as a result of passive loss restrictions retroactively imposed by the Tax Reform Act of 1986. Thus, current tax circumstances create a strong disincentive for existing owners to maintain their subsidized housing investments, while significantly diminishing the resale value of such projects as use-restricted, below-market rate rental housing.

Under these conditions, the owner of a project in a strong market area is more than likely to opt out of his or her LMSA contract at the next renewal date, prepay the mortgage, and convert or sell the project for its highest and best use. At a $75,000 condominium sales price, a family purchasing the unit would need an annual income of close to $36,000 to afford monthly debt service, property taxes, insurance payments, and condominium fees of $880 per unit--plus a $7,500 cash downpayment. By contrast, a typical family living in such a unit might have an income of $15,000 (or less if they receive Section 8 assistance) and be paying a rent of around $450. Thus the typical post-prepayment scenario in Massachusetts is likely to result in substantial tenant displacement.

With area housing prices leading the nation, a 5-10 year wait for public housing, and an estimated 10,000 homeless in cities and towns throughout the Commonwealth, low and moderate income families displaced by mortgage prepayment will have few if any affordable housing options. And beyond the hardship imposed on individual households, the cost of loosing even a few of these projects in Massachusetts could be substantial in both economic and social terms. In many cities and towns where the lack of affordable housing is of increasing concern to employers, the loss of these critical housing resources for the indigenous workforce may serve to constrain future economic growth. As well, opportunities for retaining young families in their communities of origin and for maintaining ethnic and racial diversity will be severely curtailed. In an era of escalating housing costs and lapsed federal commitment for the production of new affordable housing units, these units, once lost from the subsidized housing inventory, will likely never be replaced.

While there is much that Massachusetts and other states can do to facilitate the preservation of at-risk subsidized projects, the federal government's role is obviously critical. And while HUD could do a great deal more administratively than it is presently doing, Congressional intervention is urgently required to define how the private and public interests at stake should be balanced, to provide explicit authority for creative new approaches, and to assure the means for their implementation. In short, from our perspective in Massachusetts, legislative action on the important subject of this hearing is timely, appropriate, and indeed essential.

GENERAL POLICY GOALS

In devising legislative initiatives to address the problem of expiring use restrictions and subsidy contracts, the Subcommittee might consider the following general policy goals:

First, the primary objective should be to maximize the number of federally-assisted units that remain affordable to low and moderate income households for the longest feasible term, and to minimize hardship for existing tenants, in the most cost-effective manner. Under current market circumstances, and assuming a continuing federal mandate to assist families who cannot afford the cost of private housing, strategies aimed at preserving the subsidized inventory will be far more cost-effective than the alternative of providing replacement units. While this does not mean that every unit in every project can be preserved, it does mean that legislative initiatives should be designed to facilitate the retention of units wherever possible, and that tenants who are forced to move should be adequately protected and compensated.

At the same time, this goal will need to be accomplished in a way that is consistent with and does not breach the Government's contractual obligations to existing owners. This clearly means that owners must be able to exercise their prepayment privileges and to receive a fair and equitable return, subject to market conditions. But it does not mean, in my view, that owners are entitled to excessive or windfall profits that are solely attributable to changed economic circumstances and housing scarcity conditions, at the expense of the programs' original social objectives. While owners may assert their fiduciary duty to realize the property's highest and best use value, few subsidized housing investments were premised on the basis of significant residuals (and certainly the magnitude of gains available in today's market was not anticipated by investors twenty years ago). Indeed, the prudent exercise of fiduciary responsibility today requires an appropriate balancing of private and social objectives, to avoid costly rent strikes, litigation, and delays that are clearly not in the best interest of investors.

In short, federal policy should seek to assure that the cost of preserving existing subsidized units is equitably distributed. While tenants will have to bear some of these costs, e.g. in the form of higher rents, where feasible and appropriate, owners in turn will have to accept lower residual gains than those achievable in the marketplace, in many instances. As well, some portion of the cost of any effective preservation strategy will have to be borne by the public sector, through the use of creative financing, subsidy, and tax arrangements designed to maximize long-term public benefits. While the need for additional public funding (direct or indirect) is critical and must be recognized in any package of legislative initiatives, it is important to note that the level of public assistance required will be reduced to the extent that preservation costs are shared by the private sector.

Additionally, federal policy for the preservation of at-risk subsidized projects should allow sufficient flexibility to respond to different project circumstances. It is evident to us in Massachusetts that the ownership, market, and tenant characteristics of projects vary widely, and that the strategies required to accomplish preservation objectives will be different from case to case. In this regard, involvement of the state and local government in structuring approaches that respond to project-specific circumstances should be a key element of any legislative strategy. As a corollary to this notion, while the burden of financing the public cost of preservation must remain primarily a federal responsibility, it is not unreasonable also to expect state and local governments to shoulder a portion of this cost as well. The wide variety of housing assistance tools and techniques that have been developed at the state and local level in recent years can be put to good use in this regard, to complement federal initiatives.

Finally, while federal policy should facilitate the retention of low and moderate income units by existing owners, it should also strongly encourage the transfer of assisted projects to limited-equity cooperative, non-profit, and public housing authority ownership wherever feasible and appropriate. These ownership arrangements, which are not motivated by traditional private sector tax incentives and expectations of residual gain, will provide a far more cost-effective means of preserving the low and moderate income use of assisted projects on a long-term basis. In states such as Massachusetts, where local community development corporations and tenant cooperatives have successfully acquired a number of HUD-foreclosed developments, many expiring use projects could be similarly converted to non-profit ownership.

SPECIFIC RECOMMENDATIONS

Within this general framework, there is a need to devise a package of specific programmatic and regulatory tools to encourage and make feasible the voluntary retention of low and moderate income units by existing and new owners, while discouraging the resale and refinancing of projects at their highest and best use value. In order to preserve the maximum number of at-risk units in a cost-effective manner, this dual "carrot and stick" approach is essential. While projects with limited residual value may be maintained through incentives alone, this portion of the inventory is relatively small in states such as Massachusetts. Without sanctions or limits to deter the maximization of gains, the public cost of preserving most projects in Massachusetts will be so expensive that few units indeed will ultimately be saved.

Some specific legislative initiatives that should be considered are outlined below:

1. "Hold Harmless" Measures

HUD should be required and enabled to preserve the subsidies presently committed to at-risk projects, and to allow their reconfiguration and reuse with maximum flexibility geared to project-specific preservation needs. At a minimum, expiring LMSA contracts should be extended and adequately funded for the remaining project mortgage terms. HUD's proposed substitution of portable vouchers for project-based subsidies simply will not preserve the lower income character of most expiring use projects in Massachusetts, since tenant rent shares will increase far beyond their ability to pay. In weaker markets, the use of vouchers could precipitate mortgage foreclosure at substantial cost to the Government, especially where projects have significant rehabilitation needs.

The flexible use of interest subsidy commitments, e.g. by reconfiguring annual contract authority to provide a deeper subsidy for fewer units, could help to maintain some lower income use in projects which have developed a more mixed income character. Additionally, any unused subsidy commitments or contract authority which is freed up when mortgages are prepaid or sold out of the HUD (or GNMA) inventory should be recaptured and reallocated for use in other projects. This recapture principle should also be extended to the proceeds realized from the sale or prepayment of BMIR loans.

2. Additional Financial Assistance & Incentives

Additional financial assistance will be needed to allow a reasonable level of equity take-out by existing owners, to permit acquisition of at-risk projects by new owners, and to finance needed repairs and improvements. This assistance could take a variety of forms, all of which should be conditioned upon an extension of the project's low and moderate income use.

a. Increased Cash Flow. Allowable cash flow could be increased, e.g. by permitting a greater return on equity, recognizing an increase in equity upon which the return is based, or allowing an increase in Section 8 contract rents beyond levels justified by operating costs. A variation of this approach would permit the servicing of secondary debt on the property from current rental income. All of these measures will require increased rental subsidies for low income tenants to avoid excessive rent burdens (although in some projects tenants may be able to sustain additional rent increases within 30% of their incomes).

b. Mortgage Relief. In many projects, modification and recasting of outstanding HUD-held mortgage balances on favorable terms would greatly facilitate the retention of low and moderate income use, while allowing cash flow to increase. HUD presently grants such benefits to owners without requiring any "quid pro quo" in return. The permanent write-down of mortgage debt would go even further to facilitate this objective, and would be more cost-effective than the measures outlined above. In this regard, it should be noted that the federal government's continuing efforts to sell off the portfolio of subsidized loans currently held by HUD and GNMA is rapidly undermining the potential for creative restructuring of the underlying mortgage debt. As well, it is creating a new party (the private mortgagee) with a vested interest in prepayment and an ability to cash in on prepayment windfalls resulting from the purchase of loans at a discounted value.

c. Tax Incentives. Another approach would involve modifying the low income housing tax credit provisions of the 1986 Tax Reform Act to facilitate the use of this mechanism to preserve existing subsidized projects. As presently structured, the tax credit program does not provide sufficient incentives to alter an owner's prepayment decision, in many cases. For example, the feasibility of the credit, which is available only for units occupied by very low income households, generally depends on the ability to skew rents which is not an option under the federal mortgage subsidy programs. Extension of the credit in some form to units occupied by moderate income households in existing subsidized projects would significantly increase the amount of equity which could be generated through this mechanism. Tax credits should also be available to any project at risk of prepayment or subsidy contract expiration, regardless of its recent transfer status (currently a waiver is required if the project has been transferred within the past 10 years).

Additionally, the tax code should be changed to limit the tax on gain from a disposition of the project to the cash received, if any, in exchange for retention by the purchaser of the project's low and moderate character. In many cases, conversion of projects to market use is motivated by the investors' need to obtain sufficient cash to meet exit tax liabilities (now based on ordinary income rates rather than the capital gains rate anticipated at the time of the original investment). A significant reduction in this tax liability would permit projects in "tippable" markets to be transferred for continued low and moderate income use at below-market value. A precedent for this approach already exists in Section 1039 of the tax code, which permits the tax-deferred rollover of projects under certain (presently unworkable) circumstances.

d. Capital Grants. Finally, the option of providing direct federal deferred-payment loans or capital grants to finance the acquisition and/or rehabilitation of projects whose low and moderate income use will be retained should be considered. This strategy, analogous to the HODAG and UDAG programs, would require initially larger budgetary outlays, but is likely to be more cost-effective than either the tax incentive or rental subsidy approach in the long run. The existing Flexible Subsidy program, currently utilized to fund rehab costs and operating deficits in the form of deferred-payment loans and grants, provides another useful model which could be modified to cover reasonable acquisition costs in excess of the underlying mortgage debt.

3. Non-Profit Acquisitions

A variety of measures should be considered to facilitate the transfer of at-risk projects to tenant cooperatives, non-profit corporations, and local public housing authorities, for the reasons outlined above. These include:

a. Targeting. All of the approaches suggested to facilitate the retention of low and moderate income units could be structured to encourage non-profit ownership conversion. For example, additional LMSA contract authority, mortgage writedowns, secondary financing options, expanded tax incentives, and equity or rehab grants could be made available to non-profit sponsors on a priority basis, or could be limited to owners who provide a right of first refusal to non-profit purchasers when the property is offered for sale. Capital gains tax liability could be totally forgiven if the property is transfered to a non-profit entity. This approach would enable non-profit buyers to compete more effectively for the acquisition of at-risk projects, and would maximize the long-term public benefits of federal dollars expended for preservation purposes.

b. Right of First Refusal. Congress should also seriously consider providing a right of first refusal for tenant cooperatives, non-profit entities, and local government agencies to purchase at-risk properties at fair market value when they are offered for sale. This approach would include measures for establishing fair market value consistent with preservation objectives, as well as appropriate time frames for exercising first refusal rights, executing the purchase contract, and completing the sale. Even without the provision of the various types of financial assistance described above, this option would be feasible in weaker markets or where state or local funding is available for particular acquisitions. With federal assistance, especially if targeted towards non-profit conversions, first refusal rights could be exercised in a wide variety of circumstances where qualified non-profit purchasers exist.

4. Preventive Measures

As noted above, an effective strategy for retaining the low and moderate income use of at-risk projects must include measures to discourage owners in strong market areas from selling out the projects at today's highest and best use value. These include:

a. Post-Prepayment Regulation. Congress should consider imposing reasonable regulatory restrictions on selected post-prepayment projects, in localities where there is a severe and continuing need for lower income housing. Such restrictions might include reasonable limitations on rent increases and tenant evictions (for other than a "just cause") for a period equivalent to the remaining mortgage term. Owners could also be required to meet federal standards before converting projects to non-rental use (e.g. with regard to anti-displacement protections for very low income tenants, and/or a required set-aside of certain units for low or moderate income use).

While not precluding the exercise of prepayment privileges, these requirements would effectively limit the residual equity gains available from prepayment to a reasonable level more consistent with original owner expectations and public purpose objectives. In taking this approach, Congress would recognize that federal action to avoid further exacerbating local housing emergency conditions constitutes a legitimate exercise of federal authority, even if private rights are thereby diminished (as long as the restrictions imposed are not confiscatory).

b. Windfall Profits Tax. Alternatively, Congress could enact a special tax on the profits of conversion or refinancing that constitute an unearned "windfall" to owners in strong market areas. Such a tax would recapture the gain in excess of some value related to real economic growth or to a reasonable return on the owner's investment, consistent with the public purpose objectives of the subsidy programs. This approach would have the effect of deterring market-rate conversions, or would at least recapture a portion of residuals for reuse in preserving other at-risk projects.

5. Tenant Protections

Despite the various measures suggested above, some number of mortgage prepayments will inevitably occur. Congress should enact measures to protect tenants in these projects from arbitrary displacement, and to compensate them for the hardship that will invariably result.

At a minimum, such measures should include adequate written notice of the owner's prepayment intentions, at least one year prior to the proposed prepayment date. The notice should include sufficient information to enable the tenants to evaluate the probable impact of prepayment as well as the potential for proposing an alternative preservation plan (or for making a purchase offer). Tenants should have an opportunity to provide written comments to HUD regarding the proposed prepayment plan.

During the notice period, HUD should be required to make every effort to utilize the financial assistance tools and incentives described above to encourage the owner to retain the low and moderate income use of the property, or to sell to a qualified non-profit purchaser. If the owner chooses to exercise his or her prepayment privilege, low and moderate income tenants should be entitled to remain in occupancy for an extended notice period if they cannot locate comparable affordable housing. Finally, tenants who are displaced should be entitled to relocation benefits equivalent to those provided by the Uniform Relocation Act, in addition to rental assistance.

6. State and Local Role

As noted above, state and local governments can play a critical role in facilitating the preservation of low and moderate income use in at-risk projects, and should be integrally involved in the structuring and implementation of project-specific preservation strategies. Accordingly, owners should be required to notify the state and local government, as well as project tenants, of any proposed prepayment decision. HUD should be required to consult with state and local government representatives in the development of preservation strategies and options for individual projects.

Finally, states and localities should be encouraged to contribute available financial and other resources to complement federal assistance in retaining projects' low and moderate income use. For example, federal funds might be committed on a priority basis to match state or local assistance provided to the same project or to another project in the area. Additionally, certain types of funding, such as capital grants or additional LMSA authority, could be provided directly to the state or locality for allocation in accordance with federal criteria, to projects where their use would be most cost-effective.